ELEVEN®

Company Profile

The convenience retailing industry began in 1927 when a Southland Ice Company employee met the needs of his customers by selling bread, milk and eggs from the steps of his ice dock. The name 7-Eleven originated in 1946 when the stores were open from 7 a.m. until 11 p.m. Today, approximately 95 percent of all 7-Eleven stores in the United States and Canada are open 24 hours a day. With 18,238 convenience stores worldwide *(see inside back cover for listing of stores by country and by state)*, 7-Eleven is the premier name in the convenience retailing industry and the largest operator, franchisor and licensor of convenience stores in the world.

IYG Holding Company (IYG) owns 65 percent of Southland's common stock. IYG is 51-percent owned by Ito-Yokado Co., Ltd. and 49-percent owned by Seven-Eleven Japan Co., Ltd., the longtime 7-Eleven licensee for Japan and Hawaii.

Southland's common stock is traded on The Nasdaq Stock Market under the ticker symbol SLCM.

Corporate Mission

The Southland Corporation strives to maximize the long-term market value of shareholder equity. Our heritage is 7-Eleven. Its profitable growth and increasing dominance in convenience retailing will remain the core of our existence. We will be successful to the degree that we fulfill the needs of our customers. "What they want, when and where they want it" in a manner that provides added value, engenders loyalty and promotes a lasting relationship. To ensure Southland's continued excellence, we must retain the flexibility to anticipate opportunities and to master all forms of competitive challenge.

Our most important resource is people. Southland excels because of the quality, motivation and loyalty of every member of the Southland family. We are committed to innovation through participative involvement, and to fostering an environment of trust, respect and shared values.

As a responsible corporate citizen, Southland will conduct its business in an ethical manner with the highest integrity, while contributing to the quality of life in the communities it serves.

The ultimate measure of Southland's success is the optimal utilization of our collective resources and the perpetuation of a culture that is distinguished for its clarity of purpose, emphasis on individual responsibility and standards of excellence.

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Originally an ice company, Southland pioneered the concept of convenience in 1927 when an employee began selling basic groceries on Sunday because other businesses were closed. This innovation changed customers' expectations from merely having products available to requiring that they also be convenient. From the simple idea of giving people "what they want, when and where they want it," the convenience industry was born.

Over the years, that small business grew into a conglomerate of ice plants, dairies, distribution centers and a gasoline refinery. For 62 years, the Southland name united many diverse businesses while preserving our heritage. However, ten years ago Southland began divesting its other operations to focus on convenience retailing and has consequently decided to rename the company "7-Eleven, Inc.", better reflecting our business focus. The name is appropriate *now* because 7-Eleven's strategic initiatives have brought about such dramatic changes in performance and culture that the company truly is not the same.

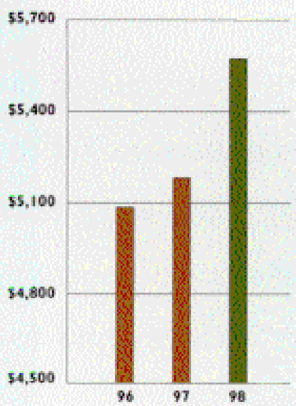
7-Eleven is again raising customer expectations as new information systems enable store managers and franchisees to anticipate customers' needs and serve them better. Each day, a network of commissaries, bakeries and distribution centers provides 7-Eleven stores with an unmatched selection of the freshest products, yielding true differentiation. This unique, proprietary infrastructure creates a strategic advantage over competitors and will enable 7-Eleven to produce sustainable and profitable growth over the long term. 7-Eleven will enter the new millennium a transformed company with new business tools and a name that reflects its identity and focus.

(Dollars in Millions, Except Per-Share Data) Years Ended December 31	1998	Change vs. Prior Year	1997	Change vs. Prior Year	1996
For the Year:					
Merchandise Sales	**$ 5,573.6**	7.6%	$ 5,181.8	1.9%	$ 5,084.0
Gasoline Sales	**1,684.2**	-5.9%	1,789.4	0.3%	1,784.9
Net Sales	**7,257.8**	4.1%	6,971.2	1.5%	6,868.9
Other Income	**92.0**	2.9%	89.4	3.5%	86.4
Total Revenues	**7,349.8**	4.1%	7,060.6	1.5%	6,955.3
Gasoline Gallons (in millions)	**1,543.0**	9.8%	1,405.7	0.5%	1,398.9
Net Earnings (1) (2)	**74.0**	5.7%	70.0	-21.7%	89.5
Net Earnings Per Common Share: (1) (2)					
Basic	**.18**		.17		.22
Diluted	**.17**		.16		.20
Payments for Purchase of Property and Equipment	**380.9**		232.5		194.4
Interest Expense, Net (2)	**91.3**		90.1		90.2
At Year-End:					
Common Shares Outstanding *(in thousands)*	**409,923**		409,923		409,923
Number of Stores Operated or Franchised by Southland in U.S. and Canada	**5,626**	203	5,423	1	5,422
Number of Stores Operated by Licensees or Affiliates in U.S. and Overseas	**12,612**	931	11,681	789	10,892
Total 7-Eleven Stores Worldwide	**18,238**	1,134	17,104	790	16,314
Total 7-Eleven Sales Worldwide	**$ 23,109.3**	-3.6%	$ 23,973.9	-1.5%	$ 24,341.2
Number of Employees (Full-time and Part-time)	**32,368**		30,323		29,532
Shareholders' Equity (Deficit) (1)	**$ (642.2)**	79.3	$ (721.5)	67.5	$ (789.0)
Total Assets	**2,415.8**	325.7	2,090.1	51.0	2,039.1

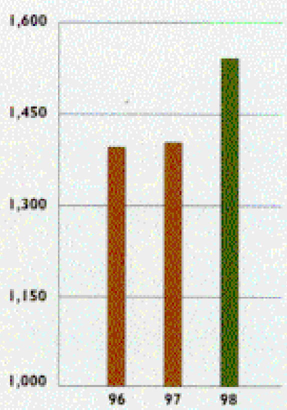
(1) Net earnings for the year ending 1998 include an extraordinary gain of $23.3 million on debt redemption as explained in Note 9 to the Consolidated Financial Statements.

(2) The Company is required to prepare its financial statements since completing the 1991 Restructuring in accordance with Statement of Financial Accounting Standards No. 15 (SFAS No. 15). Under SFAS No. 15, the liability for the Company's restructured public debt as recorded on the balance sheet includes all future undiscounted cash payments, both principal and interest. For that reason, no interest expense will be recognized over the life of these securities, although the interest payments are tax deductible. The liability is reduced by the amount of the interest payments at the time they are disbursed. Those cash interest payments, which are paid semiannually, totaled $22 million in 1996 and 1997, and $21 million in 1998. During 1998, $46 million in principal of the restructured debt was refinanced, thus reducing the restructured public debt's cash interest payments to $19 million annually beginning in 1999 through 2003, after which payments will decline due to bond maturities.

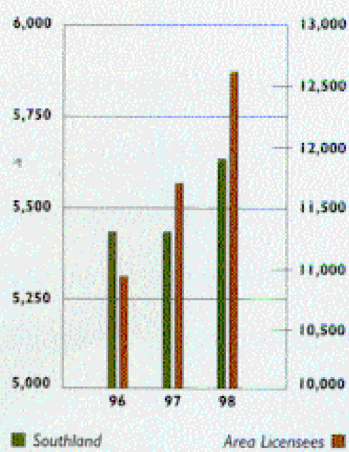
Merchandise Sales
(Dollars in Millions)



Gasoline Gallons
(Gallons in Millions)



Store Count



A Growing World-Class Operation

1998 was truly a year of accomplishment for 7-Eleven as new products and improved store-level execution combined to raise merchandise sales nearly $400 million. A strong increase in new stores contributed to this performance, but more importantly, two-thirds of the growth was due to a 5.7 percent rise in comparable domestic stores' merchandise sales — nearly four times recent trends. In fact, growth accelerated during the year with U.S. same-store sales increasing 7.2 percent in each of the last two quarters. This was the best rate in 12 years and easily outpaced the grocery industry.

In addition to the strong increase in revenues, 7-Eleven had many operational accomplishments:

- Rollout of our proprietary Retail Information System (RIS) began with nearly 700 stores operational and training had begun in 1,800 more.
- We added 299 stores through both acquisitions and construction — the largest increase since 1986.
- Successful new products contributed about one-third of the sales increase in existing stores.
- Franchisee net income grew 6.3 percent.

In addition to our domestic performance, 7-Eleven is reaching milestones worldwide:

- The 7-Eleven system added 1,134 new stores, ending the year with over 18,200 locations — by far the biggest and most recognized name in the convenience industry.
- Seven-Eleven Japan continues to improve earnings growth and add 400 stores per year despite economic problems in their country. They expect to end 1999 with 8,000 stores.
- C.P. Seven-Eleven Co., our licensee in Thailand, opened its 1,001st store last summer and ended the year with 1,105 stores.
- In 1999, President Chain Store Corp. will celebrate its 20th anniversary as 7-Eleven's licensee in Taiwan and will open its 2,000th store.

These accomplishments validate the strength of the 7-Eleven business concept. Our company has increasing momentum and has become the second-largest retail store chain in the world.

Financially Solid

Net income of $74.0 million was $4.0 million, or 5.7 percent, greater than 1997. Net earnings included an extraordinary after-tax gain of $23.3 million relating to the retirement of $45.6 million principal amount of long-term public bonds. Earnings before taxes were affected by $40.5 million of expenses outside the normal course of business. We anticipated those expenses and still met the challenge to increase profits.

Operating expenses also increased from additional stores, investments in strategic initiatives and higher labor costs due to low national unemployment. Although expense pressures were substantial in 1998, the ratio of expenses-to-sales was equal to 1997 when adjusted for a lower retail price of gasoline. Management is intensely focused on lowering costs by making the stores easier to operate so savings measures will not impact customer service.

In February 1998, Southland sold an additional $80 million of convertible bonds at an interest rate of 4.5 percent. These funds were used to retire a total of $65 million principal of public debentures, lowering debt service costs by $2 million and providing capital to help fund growth. In April, we monetized a future portion of our Japanese royalties, raising $96.5 million at the very attractive rate of 2.3 percent. The loan will be repaid from yen royalties, eliminating currency exchange rate risk.

7-Eleven same-store merchandise sales rose nearly $400 million. Two-thirds of the growth in merchandise sales was due to a 5.7 percent rise in comparable domestic stores — nearly four times recent trends.

The first area to receive RIS has already begun the process of eliminating slow-selling items, improving in-stock conditions and ensuring placement of top-selling items in all stores. In just a few months, the top stores in that market have sales increases trending higher than others.

Information System Producing Results

Most retail systems record sales history, but the 7-Eleven RIS allows managers and franchisees to be forward-looking as they determine how many of each item customers *will* want tomorrow. This subtle, but important difference helps distinguish between products with high sales, and those with high sales *potential.*

As you might expect, a small percentage of products account for the majority of sales, so it is critical that we are never out of stock on those items. By reviewing sales within a market, RIS also allows us to ensure the best-selling items are in every store. The first area to receive RIS has already begun the process of eliminating slow-selling items, improving in-stock conditions and ensuring placement of top-selling items in all stores. In just a few months, the top stores in that market have sales increases trending higher than others. Over 100 stores receive RIS each week, and we expect to have the new system in all stores by year-end.

New Products Are Important to Sales Growth

Customers' needs constantly change, and 7-Eleven's high sales of new products indicate we are identifying those needs and serving them effectively. Certainly the best example of new product innovation in 1998 was Café Cooler™, 7-Eleven's proprietary frozen cappuccino. Introduced in May, Café Cooler added $50 million in sales at a handsome margin. In 1999, 7-Eleven will introduce Früt Cooler™, a low-fat smoothie-like fruit drink that received excellent customer acceptance in market tests.

7-Eleven stores also successfully introduced popular premium domestic and foreign wines in time for the holiday season. Southland teamed with Seven-Eleven Japan to obtain better pricing on selected French wines, utilizing the buying power of 13,000 stores. Early results were impressive, with wine sales up 32 percent in the fourth quarter.

Fresh Foods Distinguish 7-Eleven

It seems everyone's lives are getting busier, and many are eating out more often to save time. To serve these customers, 3,280 7-Eleven stores are receiving deliveries of fresh foods and pastries, prepared daily by third-party operators. 7-Eleven introduced chilled sandwiches — the Super Big Sub™ and The Pita™ — in the summer, and hot lunch and breakfast sandwiches in the fall. These food lines match customers' preferences for taste and temperature throughout the year. Because customers visit their 7-Eleven an average of over four times per week, new varieties of these sandwiches are developed monthly to keep our menu as fresh as our food.

Our bakery operators produce World Ovens® donuts fresh every day to offer morning customers a delicious complement to our award-winning coffee. In 1998, the bakeries also began developing pastries typically consumed in the afternoon to conveniently offer customers a delicious snack and improve the use of our new pastry case.

Tobacco

The recent settlement of tobacco litigation resulted in an increase in the cost of cigarettes, which will have to be passed along to customers. Because our retail price adjustments should cover the cost increase, this will not directly impact our dollar gross profit, but it will arithmetically reduce margin percentages. With tobacco products comprising over 20 percent of merchandise sales, we also expect an inflationary effect of approximately 4 percent.

Gasoline

7-Eleven stores increased gasoline sales by 137 million gallons in 1998, and volumes in new stores were typically double their market averages. We are in an excellent position to continue this trend because CITGO, our gasoline supplier, is still a leader in the industry:

- Through its parent, PDVSA, CITGO has access to over 79 billion barrels of proven reserves, over *four times* that of Exxon and Mobil combined.
- PDVSA is one of the lowest-cost producers; while others continue looking for oil, they are simply extracting it.
- CITGO has the fourth-largest refining capacity and marketing network in North America.

In other words, other companies are merging to create the synergies that CITGO already has.

New Stores Add Momentum

7-Eleven added 299 stores in 1998, the most in over a decade. Of these, 155 stores came from acquisitions and 144 were internally developed. Our strategy is to add stores in existing markets, thereby increasing brand presence and improving economics for the distribution system and commissaries. The acquisition of Christy's Market provided a "critical mass" of stores to allow daily delivery of fresh products in the New England area.

A growing store base also produces opportunities for career advancement and expands our franchise system. The additional stores led to the creation of positions for two new division managers, four senior-level market managers and about 25 field consultants. Providing a dynamic career path helps Southland attract and retain the best and brightest people in a tight labor market.

Finally, sales improvements and progress on our strategic initiatives have positioned Southland for better returns to shareholders. While we feel that our stock price is best advanced by accelerating returns from our strategic initiatives, we want to be certain that the financial community associates the positive momentum of 7-Eleven's operations with the company as an investment. To that end, we are seeking shareholder approval to change Southland's name to 7-Eleven, Inc., better reflecting our identity and business focus.

I want to thank all 7-Eleven employees and franchisees for working to exceed customers' expectations every day. I am also grateful to our suppliers and strategic partners for helping us serve our customers' needs and appreciate the continued support of our majority owners and other stakeholders. These collective efforts ensure that 7-Eleven will continue to be the premier name in convenience retailing.

Clark Matthews

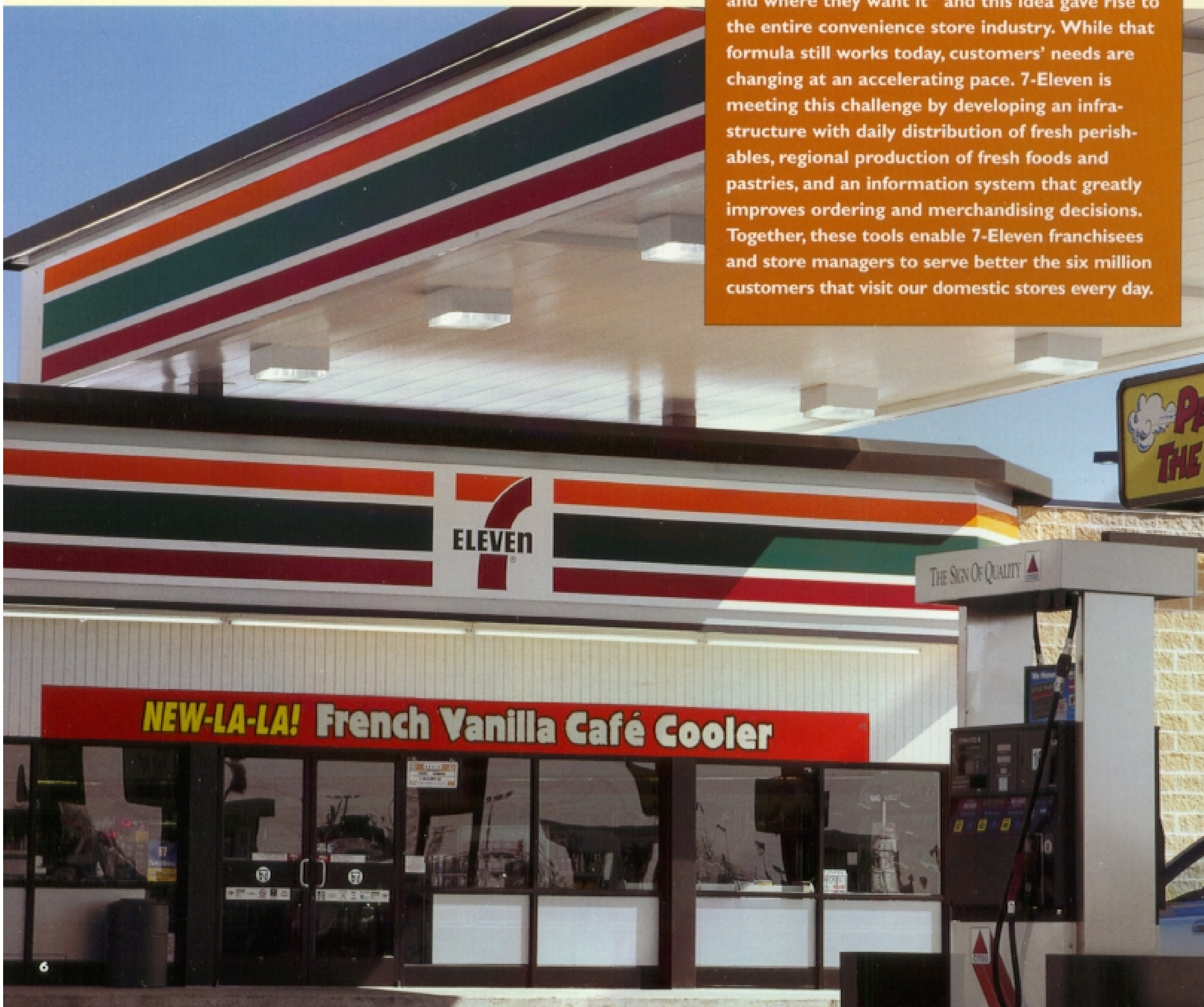
Clark J. Matthews, II
President and Chief Executive Officer
March 12, 1999

Sales improvements and progress on our strategic initiatives have positioned Southland for better returns to shareholders.

Opportunity begins with a concept.

The Convenience Store Success Story

7-Eleven stores were born from the simple concept of giving people "what they want, when and where they want it" and this idea gave rise to the entire convenience store industry. While that formula still works today, customers' needs are changing at an accelerating pace. 7-Eleven is meeting this challenge by developing an infrastructure with daily distribution of fresh perishables, regional production of fresh foods and pastries, and an information system that greatly improves ordering and merchandising decisions. Together, these tools enable 7-Eleven franchisees and store managers to serve better the six million customers that visit our domestic stores every day.



With 18,238 stores worldwide, 7-Eleven is the largest and most recognized convenience store chain in the world. Of these, 5,626 are operated or franchised by Southland in the United States and Canada. Franchisees operate 53 percent of those stores and their sales are included in the company's revenues. Area licensees and affiliates operate 440 U.S. stores, as well as 12,172 in 16 other countries and two U.S. territories; royalties from these stores are included in Southland's Other Income. With $7.35 billion in revenues (excluding licensees and affiliates), 7-Eleven is the largest independent convenience store company and the ninth-largest food and drug retailer in the United States.

7-Eleven is implementing a leading-edge approach that consistently allows store operators and franchisees to satisfy customers. A proprietary new retail information system helps store operators select products *their* customers desire and estimate demand so each item stays in stock. A network of third-party-operated commissaries and bakeries produces fresh foods for over 3,200 stores each day with quality, consistency and a variety unmatched in the convenience store industry. 7-Eleven stores can sell fresher products due to a distribution system that combines fresh foods with products from other vendors and delivers them to the stores on a daily basis. This infrastructure of information systems, daily distribution and fresh foods differentiates 7-Eleven from competitors by allowing our stores to offer newer and fresher products and to be in stock on fast-moving items.

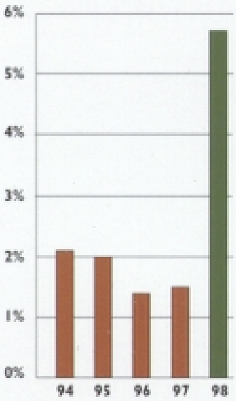
The 7-Eleven business concept of aggressive merchandising and tightly concentrated stores that are efficient to service and manage has already proven successful around the world. Seven-Eleven Japan has been that country's most profitable retailer for five years, and our three largest Asian licensees added over 900 stores, despite difficult economies. 7-Eleven's Mexican affiliate is experiencing double-digit sales increases with this business concept and plans to accelerate store openings in 1999.

1998 ended with the best merchandise sales increases in 12 years and a renewed confidence in the strategic initiatives that will distinguish 7-Eleven from other convenience stores. Southland is committed to achieving appropriate returns for its shareholders, helping 7-Eleven franchisees grow their business, providing a rewarding workplace for employees and contributing to the quality of life in the communities we serve.

In 1998, 7-Eleven sold an average of 1 million cups of its rich coffee each day — well more than a cup for every person in America each year. 7-Eleven's exclusive blend has been voted "best coffee in town" in many cities around the U.S.

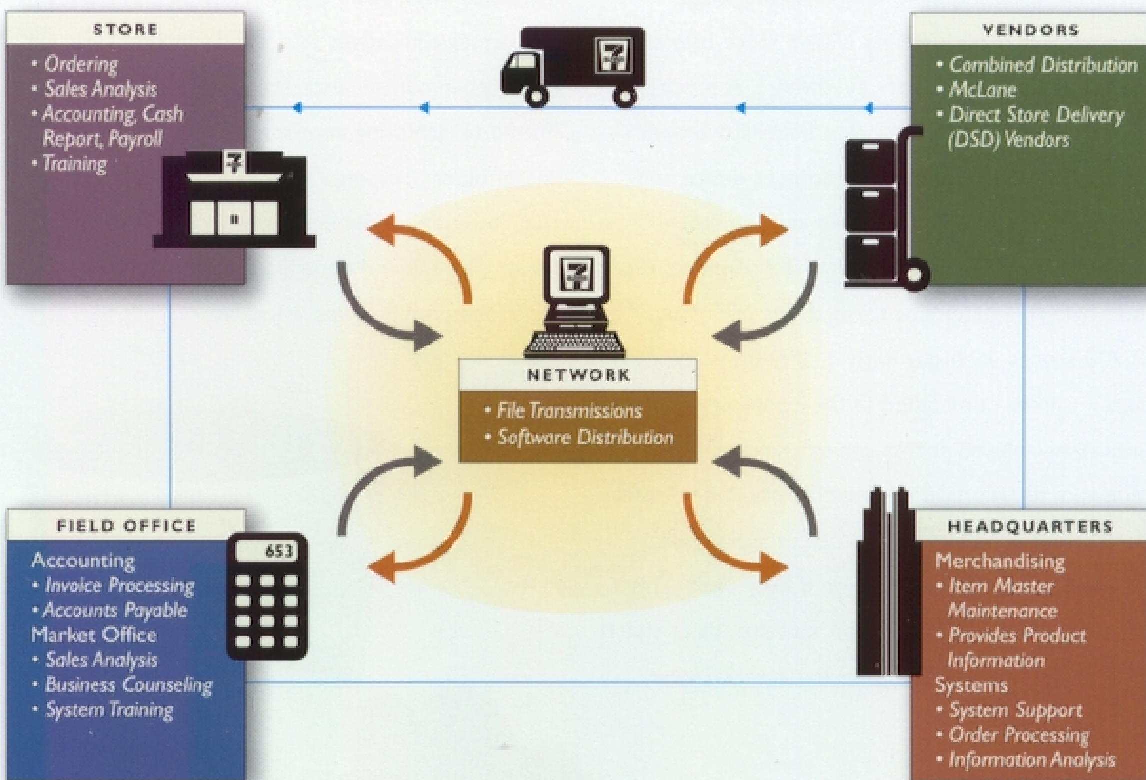
In order to utilize selling space efficiently, we must understand what is selling, what is not selling and how much of each item will be needed. The 7-Eleven Retail Information System (RIS) enables franchisees and store managers to practice "retailer initiative," whereby merchants exercise control of product selection, rather than letting delivery vendors choose for them. By knowing what sells in their stores, operators can select the proper assortment of products for their customers.

Same-Store Merchandise Sales



Stay in Stock on Best-Selling Items

The average merchandise sale in a 7-Eleven is a little over three dollars, and when customers come in, they want to buy a few specific items. The most important job at 7-Eleven is ordering to stay in stock on fast-moving products. RIS provides information on influences to customer buying behavior — such as weather, holidays and upcoming advertising — along with recent sales trends to help store operators forecast demand for *each* item. If our stores do not consistently have the products customers want, they will quickly find another retailer that will serve their needs.



By electronically connecting all parties in the 7-Eleven supply chain, RIS creates a higher level of coordination and much better decision-making. Store operators have actual sales information presented in logical formats and are able to order more effectively. Receiving exact orders in an organized fashion allows vendors to provide better service to the stores. Field offices are able to reduce administration costs by receiving information in electronic format. Headquarters merchandising staff are able to judge new product acceptance and communicate upcoming advertising and promotions from manufacturers that will affect sales.

Delete Slow-Moving Items

Slow-moving inventory is perhaps the biggest opportunity — and challenge — at 7-Eleven. In addition to their cost, unwanted products limit space for those with higher sales potential. RIS ranks item sales within a category and organizes them by type and package size to assist store operators in deciding which products to delete. From RIS information in one market, we learned that the slowest-selling half of SKUs produced less than one percent of sales. Those items can be eliminated to create space for higher potential products.

Choose New Items

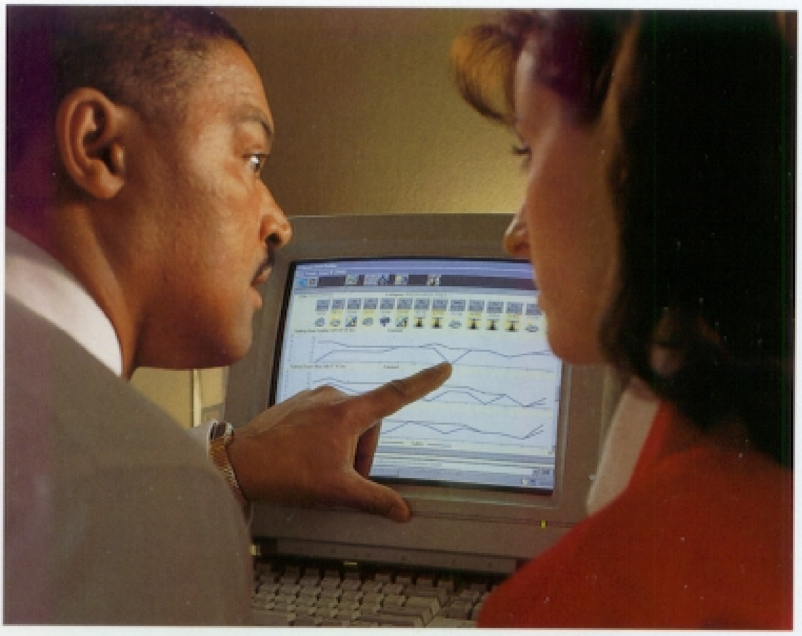
The corporate Merchandising department reviews thousands of new products each year and recommends products that have high sales potential in 7-Eleven stores. Franchisees and store managers look at a matrix of sales by category to see if any new products might sell more than items already in the store. The breadth of offerings is reviewed to look for opportunities to try new types of products. They then choose those items they believe will appeal to their customers. With the market-level data from RIS, field consultants also help ensure they carry the local top-selling items. In this way, inventory is managed to understand customers' needs better and serve them more effectively.

Integrated Ordering

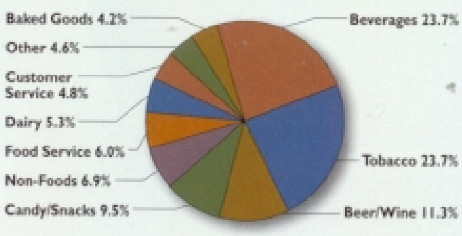
When products are chosen and quantities are estimated, there remains the need to communicate those orders. RIS connects the store with fresh-food production facilities, distributors and selected suppliers. The process of producing item-level forecasts also creates the order, so store managers and franchisees have more time to spend on sales analysis and product selection. RIS also facilitates vendor payment and enables better support from the Merchandising and Logistics departments.

Perhaps the most important aspect of the system is that these activities take place in the store, where we can capitalize on the store managers' and franchisees' knowledge of their customers, neighborhoods and local events. Store operators get immediate verification of their merchandising changes. That learning can then be communicated across the 7-Eleven system to increase sales in other stores.

Having actual by-item sales information enables store managers and franchisees to forecast demand from a basis of fact, rather than intuition. The ability to verify merchandising actions is key to learning so that good ideas are identified and replicated throughout the organization. Field consultants meet twice each week with store managers and franchisees to review sales progress and continue training on RIS.



Merchandise Sales by Category



New Products Increase Sales

Customers' tastes change frequently, and 7-Eleven stores introduce a constant stream of new items so customers have convenient access to the products that will best meet their needs. The most successful new product in 1998 was Café Cooler, a frozen cappuccino especially appealing to our female customers. Women comprise about one-third of 7-Eleven's customer base, but were responsible for about half of all Café Cooler sales. This beverage complemented our coffee and Slurpee® businesses, which also showed strong increases.

Product life-cycles are becoming shorter, so while it is important to add new products, it is even more important to be the *first* to offer them. New products typically offer higher margins early in their life. In 1998, 7-Eleven led the industry with the national rollout of prepaid cellular phone cards — and even sold the phones that use them. At nearly $100 each, these cell phones are a good value, and change customers' perceptions about the types of products available at 7-Eleven. Prepaid cellular products nearly doubled category sales in the fourth quarter.

7-Eleven continues to be innovative, finding new ways to offer popular products. Mexican quick-serve food has one of the largest growth trends, so 7-Eleven is nationally introducing El Taco™, a taco meat product shaped like a hot dog that is cooked on the roller grill and served on a flour tortilla. Customers "dress" the El Taco with free toppings from our condiment bars.

Early in 1998, Southland began testing the world's first automated financial services centers in 37 Austin, Texas, stores. These devices cash checks, sell money orders and phone cards, perform Western Union® money transfers and accept bill payments 24 hours a day, 365 days per year. Customer reception has been very positive, with the best stores cashing nearly 1,000 checks per month. 7-Eleven and project partners are now developing the next generation of hardware and software and expect to begin rollout to a market of over 200 stores late in 1999, with other markets to soon follow.

Merchandising for Convenience

Customer tastes evolve as newer and better products become available, but they also change predictably throughout the year. Many product categories have definite seasonality. Merchandise is frequently repositioned during the year so customers can easily find what they want. Store operators also analyze sales to put the fastest-selling items at eye level; children's products are positioned lower on the shelf while adult products are placed higher. Whether sourcing new products, reducing costs to enable lower retail prices or simply positioning for quick access, increasing sales at 7-Eleven ultimately depends on strong merchandising.

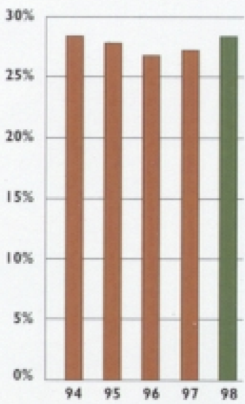
Since 1994, wine sales in supermarkets have grown almost 50 percent, and demographic trends are expected to support further increases. 7-Eleven is working with distributors to offer its customers a full line of premium wines. The program was introduced late in 1998, and sales in some stores exceeded 100 bottles per day during key holidays.

THE 7-ELEVEN MERCHANDISING SUCCESS STORY

Café Cooler was by far the most successful new product in 1998. A competitor created a market for frozen cappuccino at a premium retail price, and 7-Eleven was able to offer an excellent product at a much better value to the customer. Introduced in May, this new item accounted for $50 million in sales. In 1999, 7-Eleven intends to use that tactic again with Früt Cooler, a delicious, low-fat smoothie-like drink with real fruit.

Opportunity begins with understanding.

Operating, Selling, General and Administrative Expense as a Percent of Sales



Combined Distribution Centers

Southland's system of combined distribution centers (CDC), owned by third parties and operated to serve 7-Eleven stores, bring fresh Deli Central® foods and other "time-sensitive" items on a daily basis to nearly 60 percent of our stores. In this system, suppliers prepare one delivery per day from an aggregate of actual store orders, rather than make hundreds of smaller deliveries. These large orders are separated for the individual store at the CDC and delivered late at night.

Serving the stores every day provides 7-Eleven with real competitive advantages:

- Products such as milk and bread are much fresher because the time from manufacture through delivery is reduced to hours, compared to days for the traditional vendor-delivered method.
- Because the deliveries occur at night — usually within 15 minutes of a scheduled appointment — merchandise is put away during the overnight shift, utilizing labor more efficiently. Having fewer trucks during the day relieves congestion and frees the parking lot for customers.
- CDCs provide access to popular products not traditionally found in convenience stores due to the distribution hurdles of supplying limited amounts to a large number of stores.
- Spoilage and excess inventory of items like dairy and bread are minimized due to frequent replenishment.
- 7-Eleven stores actually receive the products they need to satisfy their customers. In a vendor delivery system, the last stores on a route must often make do with the product remaining on the truck.

A key component of 7-Eleven's strategic initiatives, combined distribution centers bring several advantages to both merchandising and operations. CDC delivery makes it possible to have centralized production of fresh food and pastries and give access to a limitless array of new products by simplifying distribution. Deliveries occur late at night, helping the store stay ready for business during the busiest parts of the day.

Among the most important benefits of CDCs is reduced out-of-stocks because of more frequent deliveries. Inventories can be replenished quickly if unexpected demand depletes stock on hand. CDCs also allow the timely introduction of immediate sales opportunities, such as sports team-related products immediately after a championship.

Direct store delivery vendors often have quantity discounts, which benefit high-volume stores but place others at a disadvantage. Through distribution efficiencies, CDCs allow all stores in an area to pay the same amount for an individual item. In addition to their other benefits, costs through the CDC are generally lower than the direct store delivery system.

Commissary / Bakery

Quality and selection are the keys to success in fresh foods, and the third-party-operated commissaries that serve 7-Eleven stores produce the freshest items daily in an evolving menu that keeps the product mix interesting. At year-end, this service was available to 3,280 stores, and plans are to provide this strategic advantage to over 500 additional stores in 1999.

In 1998, 7-Eleven made its most aggressive move into fresh foods by introducing four new food lines. In early summer, 7-Eleven launched the hearty Super Big Sub and a new line of improved pita sandwiches. In late fall, 7-Eleven added tasty heated sandwiches called "Warm-Ups" to cater to customers' preference for hot foods when the weather turns colder. By developing different varieties of sandwiches within signature lines of offerings, we create product identity while keeping our menu fresh.

A recent study documented the trend away from the traditional breakfast meal at home, saying Americans frequently eat breakfast in the car. To capitalize on this trend, 7-Eleven introduced a new line of hot breakfast sandwiches in the fall. These products have been well-received as a delicious complement to 7-Eleven's award-winning coffee.

Fresh donuts and pastries delivered each day from World Ovens bakeries also provide a great morning treat. When combined with sales of breakfast sandwiches, nearly one out of four morning customers begin their day with a great meal from 7-Eleven. After breakfast, the pastry case is restocked with fresh gourmet cookies, cakes and other snacks for the afternoon.

One-fourth of morning customers begin their day with breakfast at 7-Eleven. Delicious World Ovens pastries, made fresh every day by bakery experts such as Pillsbury, complement 7-Eleven's award-winning coffee. This facility in Lewisville, Texas, produces an average of 30,000 pastries and snacks each day.

7-Eleven's strategic initiatives and processes are great tools that create competitive advantages, but it is our store managers and franchisees that actually satisfy customers. The entire corporate focus is to give store operators the products that customers want and the tools that enable them to be successful.

Employees

The challenges of running a store can leave little time for finding new ways to grow sales, so Southland is working to make the stores easier to operate. For example, to help keep the refrigerator vault doors stocked, 7-Eleven is working with beverage vendors to get more frequent deliveries, reducing inventory for easier access to products in the back of the vault. In addition, some vendors have rescheduled deliveries to off-peak hours, relieving congestion in the parking lot and allowing operators to focus on customers during the day.

7-Eleven's strategic initiatives help achieve sustainable sales increases for Southland; however, they are also creating opportunities for employees.

As a store manager in Dallas, Andy Taing used RIS to increase beer sales in his store 35 percent in six weeks. After reviewing item-level sales, he deleted slow sellers and devoted more space to the fastest-selling products. Andy has since been promoted to field consultant and now coaches other store managers on the benefits of RIS.

Southland has already promoted several people who have produced large sales increases through the use of RIS or from exceptional merchandising of new products and fresh foods.

Franchisees

Improved cooperation and communication highlighted the relationship between 7-Eleven and its franchisees in 1998. As a part of this effort, 7-Eleven senior management meets with the National Coalition of Associations of 7-Eleven Franchisees at their board meetings. In addition, franchise division vice presidents increased their communication and participation with the 7-Eleven Franchise Owners Associations located in their areas of operation. 7-Eleven has an advisory council of franchisees that provides ongoing input on numerous franchisee matters and assists in developing and implementing new programs. Southland appointed the five senior officers of the National Coalition to this group. These five officers represent about 2,000 franchisees across the country and contribute their perspective on the opportunities and challenges of running a 7-Eleven store. Southland also retained five retired franchisees as liaisons to provide their insight on important business issues.

In 1998, the Company held one of its five "University of 7-Elevens" in conjunction with the National Coalition's annual convention. The "university" provides an excellent opportunity to present merchandising case studies, taste potential new food offerings and demonstrate product display techniques. The greater sense of teamwork and cooperation between Southland and franchisees has already contributed to higher sales and profits within the 7-Eleven system.

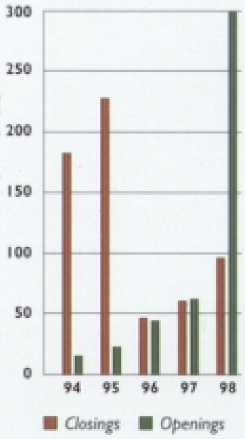
Pictured are Clark Matthews, Southland's President and Chief Executive Officer; Tariq Khan, Chairman of the National Coalition of Associations of 7-Eleven Franchisees; and Jim Keyes, Southland's Chief Operating Officer.

THE 7-ELEVEN FRANCHISEE SUCCESS STORY

Tariq Khan, the Chairman of the National Coalition of Associations of 7-Eleven Franchisees, worked extensively with Clark Matthews, Jim Keyes and others in 7-Eleven's management to achieve an improved relationship and expanded cooperation in 1998. Khan notes that "the meetings between Southland's senior management and the National Coalition's Board were very productive." Khan also believes that Southland's efforts clearly demonstrate its commitment to 7-Eleven franchisees and the entire franchise system. Khan notes approvingly that Southland today "has a definite direction and that 7-Eleven franchisees believe in their franchisor and the new items being developed."

Opportunity begins with people.

Store Unit Activity
(Includes relocation, rebuild and seasonal activity)



New Stores

In 1998, Southland added 299 stores — 155 through acquisition and 144 internally developed sites — the most in 12 years. All new stores were built in existing markets, increasing market presence and lowering costs by improving distribution economics. In addition to being individually profitable, new stores convey the momentum and success of 7-Eleven to the marketplace.

The company acquired two chains in 1998 — 'red D mart' in the Midwest and Christy's Market in New England — to complement existing 7-Eleven stores and increase 7-Eleven's prominence in these important markets. The 135 Christy's stores combine with 90 existing New England 7-Eleven stores to create sufficient economies of scale to bring daily distribution of fresh foods and perishables to that area.

New stores create excitement and invigorate the 7-Eleven team with their fresh, new facilities and opportunity to grow sales. An expanding market presence also demonstrates the success of 7-Eleven to customers and commitment to the community to civic leaders.

Typically in growth areas, new stores quickly match the average merchandise sales for their market areas, and larger gas facilities more than double the gasoline volume of existing stores. In addition to the merchandising benefits, 7-Eleven's strategic initiatives are improving new store economics from a cost basis as precise ordering and more frequent replenishment decrease inventory needs. New stores are being designed with reduced back areas, which saves building and land costs. Smaller lot requirements also give greater flexibility in searching for new sites.

International

7-Eleven and its licensees added more than 1,100 stores in 1998, and with a total of 18,238 stores, 7-Eleven is the world's second-largest retail store chain. Seven-Eleven Japan added over 400 stores for a total of 7,605 stores, and C.P. Seven-Eleven, our licensee in Thailand, added over 200. We expect our Taiwanese licensee to open its 2,000th store in 1999. These companies are accomplishing this growth despite distressed economies — illustrating the universal need for convenience and demonstrating the strength of the 7-Eleven business concept. The companies that license 7-Eleven overseas are typically large, successful businesses and household names in their countries.

In addition to the growth of our Asian licensees, 7-Eleven's affiliate in Mexico is enjoying success by following the 7-Eleven business model.

Adopting certain products that are successful in the U.S. helped Mexican 7-Eleven stores experience double-digit real (after-inflation) sales increases. In 1999, they plan to open 50 new stores and begin combined distribution.

In addition to a successful operating model, an advantage of being a part of a large retail chain is improved economies of scale. Southland is more aggressively joining forces with its licensees around the world, effectively tripling buying power and gaining access to new products. U.S. and Japanese stores teamed to lower costs on certain premium wines. Southland "exports" new products as well; licensees will add Café Cooler to thousands of stores in 1999.

Coordination between different cultures and languages can be a challenge, but the companies that comprise 7-Eleven are cooperating to lower costs and get access to new products. Senior 7-Eleven management met with each licensee individually in 1998, and this year will host the first global merchandising forum. Together, the entire 7-Eleven family is working to leverage all the strengths of a worldwide business network.

Although most people think of it as the "little store on the corner," with 18,238 stores, 7-Eleven is the second-largest retail store chain in the world. Located primarily in North America, Japan and Southeastern Asia, 7-Eleven stores are typically market leaders in both numbers of stores and average sales. The strategy of anticipating customer needs, diligently staying in stock and efficiently using selling space has been immensely successful in many foreign countries. The success of 7-Eleven's business concept stems from serving the universal need for convenience and quality.

(Dollars in Millions, Except Per-Share Data)

Years Ended December 31	1998	1997	1996	1995	1994
Merchandise sales	**$ 5,573.6**	$ 5,181.8	$ 5,084.0	$ 5,063.7	$ 5,066.0
Gasoline sales	**1,684.2**	1,789.4	1,784.9	1,682.1	1,618.5
Net sales	**7,257.8**	6,971.2	6,868.9	6,745.8	6,684.5
Other income	**92.0**	89.4	86.4	78.5	74.6
Total revenues	**7,349.8**	7,060.6	6,955.3	6,824.3	6,759.1
LIFO charge	**2.9**	0.1	4.7	2.6	3.0
Depreciation and amortization	**194.7**	196.2	185.4	166.4	162.7
Interest expense, net	**91.3**	90.1	90.2	85.6	95.0
Earnings before income taxes and extraordinary gain	**82.6**	115.3	130.8	101.5	73.5
Income taxes (benefit)	**31.9**	45.3	41.3	(66.1)[a]	(18.5)[b]
Earnings before extraordinary gain	**50.7**	70.0	89.5	167.6	92.0
Net earnings	**74.0**[c]	70.0	89.5	270.8[d]	92.0
Earnings before extraordinary gain per common share:					
Basic	**.12**	.17	.22	.41	.22
Diluted	**.12**	.16	.20	.40	.22
Total assets	**2,415.8**	2,090.1	2,039.1	2,081.1	2,000.6
Long-term debt, including current portion	**1,940.6**	1,803.4	1,707.4	1,850.6	2,351.2

(a) Income taxes (benefit) include an $84.3 million tax benefit from recognition of the remaining portion of the Company's net deferred tax assets.
(b) Income taxes (benefit) include a $30 million tax benefit from recognition of a portion of the Company's net deferred tax assets.
(c) Net earnings include an extraordinary gain of $23.3 million on debt redemption as explained in Note 9 to the Consolidated Financial Statements.
(d) Net earnings include an extraordinary gain of $103.2 million on debt redemption.

Some of the matters discussed in this annual report contain forward-looking statements regarding the Company's future business which are subject to certain risks and uncertainties, including competitive pressures, adverse economic conditions and government regulations. These issues, and other factors, which may be identified from time to time in the Company's reports filed with the SEC, could cause actual results to differ materially from those indicated in the forward-looking statements.

RESULTS OF OPERATIONS

Summary of Results of Operations

The Company's net earnings for the year ended December 31, 1998 were $74.0 million, compared to net earnings of $70.0 million in 1997 and $89.5 million in 1996.

(Dollars in Millions, Except Per-Share Data)

Years Ended December 31	1998	1997	1996
Earnings before income taxes and extraordinary gain	$ 82.6	$ 115.3	$ 130.8
Income tax expense	(31.9)	(45.3)	(41.3)
Extraordinary gain on debt redemption (net of tax)	23.3	—	—
Net earnings	$ 74.0	$ 70.0	$ 89.5
Net earnings per common share — Basic	$ .18	$ .17	$ .22
Net earnings per common share — Diluted	$ .17	$ .16	$ .20

The decline in the Company's earnings before income taxes and extraordinary gain is primarily due to several material charges incurred in 1998. These charges include $14.1 million associated with write-offs of computer equipment and development costs, $11.4 million for deletion of excess or slow-moving inventory and $7.6 million in severance and related costs. In addition, costs associated with the implementation of the Company's strategic initiatives continue to unfavorably impact short-term profits (see Operating, Selling, General and Administrative Expenses).

Management Strategies

Since 1992, the Company has been committed to several key strategies that it believes, over the long term, will provide further differentiation from competitors and allow 7-Eleven to maintain its position as the premier convenience retailer. These strategies include: upgrading and expanding the store base; a customer-driven approach to product selection; an everyday-fair-pricing policy on all items; daily delivery of fresh perishable items; introduction of high-quality, ready-to-eat fresh foods; and the implementation of a state-of-the-art retail information system.

Prior to 1997, the Company focused on upgrading its store base, through remodeling existing stores and closing underachieving stores. In late 1996, the Company completed the most extensive remodeling program in its history. Current upgrade programs will focus on retail information systems, food service and other merchandising programs. Beginning in late 1996, the Company began to focus its efforts on growing its store base. The Company recorded the first increase in its total store base in 10 years in 1997. Store openings or acquisitions over the last three years totaled 299, 61 and 44 in 1998, 1997 and 1996, respectively. Store growth in 1998 was aided by acquisitions of 135 Christy's Market convenience stores and 20 'red D mart' stores. Also, an additional 45 stores were under construction at December 31, 1998. In 1999, new store openings are once again expected to outpace closings, with the expansion occurring in existing markets to enhance the economies of scale associated with the Company's fresh food and combined-distribution initiatives. In recent years, the Company has pruned its store base, closing or disposing of those stores that either could not support its strategies, were not expected to achieve an acceptable level of profitability in the future or had leases which expired. As a result, store closings during the past three years totaled 96, 60 and 46 in 1998, 1997 and 1996, respectively. The Company expects to close slightly fewer stores in 1999 than it did in 1998. The store additions and closings discussed above include relocations, rebuilds and seasonal activity.

The customer-driven approach to merchandising focuses on providing the customer a selection of quality products at a good value. This is being accomplished by emphasizing the importance of ordering at the store level, removing slow-moving items and aggressively introducing new, high-potential products in the early stages of their life cycle. This process represents an ongoing effort to satisfy customers' ever-changing preferences.

The Company's everyday-fair-pricing strategy is designed to provide consistent reasonable prices on all items. When the everyday-fair-pricing strategy was introduced, some product prices were lowered, while others were increased to achieve more consistency. Going forward, as the Company achieves lower product costs, it plans to migrate toward lower retail prices.

Daily delivery of high-quality ready-to-eat foods, along with other time-sensitive or perishable items, is another key management strategy. Implementation of this strategy includes third-party development and operation of combined distribution centers ("CDC"), fresh-food commissaries and bakery facilities in many of the Company's markets around the country. The commissary and bakery ready-to-eat items, like fresh sandwiches and pastries, along with goods from multiple vendors such as dairy products, bread, produce and other perishable goods,

are "combined" at a distribution center and delivered daily to each store. In addition to providing fresher products, improved in-stock conditions and quicker response time on new items, the combined distribution is also intended to provide lower product costs, in part from vendors' savings, through this approach. At the end of 1998, approximately 3,300 stores were serviced by daily distribution facilities. Expansion of these programs to another 500 stores is anticipated in 1999.

The development of a retail information system ("RIS") began in 1994. The initial phase, completed in early 1996, involved installing in-store processors ("ISP") in each store to automate accounting and other store-level tasks. The current phase involves the installation of point-of-sale registers with scanning capabilities, as well as tools on the ISP to assist with ordering and product assortment, and a hand-held unit for ordering product from the sales floor. At the end of 1998, point-of-sale registers had been installed in nearly 2,500 stores in either a live or training mode. After completion, the system will provide each store, along with the Company's suppliers and distributors, on-line information to make better decisions in anticipating customer needs. Management believes that the effective utilization of daily sales data gathered by the system will improve sales through reducing out-of-stock incidents and will enhance each individual store's product mix to better match customers' needs. In addition, the system will assist with monitoring inventories to better control shortage and product write-offs. While implementation costs during the rollout phase are expected to exceed the short-term benefits, the anticipated long-term benefits of this system, coupled with further cost reductions resulting from automation, are expected to help the Company reach its goal of sustained profitable growth over the long term. This phase of the system is currently expected to be fully operational for all stores by the fall of 1999.

(Except where noted, all per-store numbers refer to an average of all stores rather than only stores open more than one year.)

Sales

The Company recorded net sales of $7.26 billion for the year ended December 31, 1998, compared to sales of $6.97 billion in 1997 and $6.87 billion in 1996. The increase in net sales over the last two years was a result of same-store merchandise sales growth, combined with an increase in stores. The following table illustrates the growth in merchandise sales:

Merchandise Sales Growth Data *(per-store)*

Increase/(decrease) from prior year

Years Ended December 31	1998	1997	1996
U.S. same-store sales growth	**5.7%**	1.5%	1.4%
U.S. same-store real sales growth, excluding inflation	**3.1%**	0.6%	(1.0)%
7-Eleven inflation	**2.5%**	0.9%	2.4%

The fourth quarter of 1998 was the sixth consecutive quarter of favorable U.S. same-store real sales growth, the longest stretch this decade. Same-store merchandise sales growth was 7.2% over the last six months, which is also the largest such increase this decade. The Company believes that this trend is, in part, a result of changes made to the merchandising organization and its processes in the second quarter of 1997.

While average per-store merchandise sales growth has been fairly consistent among the various geographical areas, category results have been mixed:

Categories with significant 1998 merchandise sales increases were cigarettes, Café Cooler, fresh foods/bakery, coffee, prepaid phone cards and Slurpee. **Cigarette sales** increased primarily due to retail price increases associated with manufacturer cost increases, which have had an unfavorable impact on margin. **Café Cooler**, a frozen non-carbonated drink introduced in the spring, provided incremental growth in per-store sales. **Slurpee** and **non-carbonated drink** sales are up substantially, partially due to the introduction of new products, flavors and packaging. The Company has plans to revitalize certain mature categories like soft drinks/fountain and candy, which have had declining sales over the last couple of years. Other categories which had slight declines in 1998 include newspapers/publications and packaged bakery/bread.

Categories driving the 1997 merchandise sales increase were coffee, Slurpee, non-carbonated beverages, tobacco, services, fresh bakery and roller grill products. Categories that were flat or had slight declines included fountain drinks, bread, candy and soft drinks.

During 1998, the Company's retail price of gasoline dropped 18 cents per gallon, or 14.3%. As a result, gasoline sales dollars per store decreased 10.6% in 1998, compared to 1997, after a decline of 0.9% in 1997 versus 1996. Gas gallon sales per store increased 4.2% when compared to 1997, primarily due to new store volumes, which are higher than existing stores. Contributing to the

1997 decrease was a .7% decline in average per-store gallon volume with retail gasoline prices being virtually flat compared to 1996.

Other Income

Other income of $92.0 million for 1998 was $2.6 million higher than 1997 and $5.7 million higher than 1996. The improvement over the last two years is a combination of increased royalty income from licensed operations, combined with fees generated from higher levels of franchising activity. In 1998, nearly $53 million of the royalties were from area license agreements with SEJ. One year following repayment of the Company's 1988 yen-denominated loan, currently projected for 2001, royalty payments from SEJ will be reduced by approximately two-thirds in accordance with terms of the license agreement.

Gross Profits

Merchandise Gross Profit Data

Years Ended December 31	1998	1997	1996
Merchandise Gross Profit — dollars in millions	**$ 1,927.6**	$ 1,828.4	$ 1,787.7
Gross profit margin percent	**34.58%**	35.29%	35.16%
Increase/(decrease) from prior year — all stores			
Average per-store gross profit dollar change	**3.2%**	2.3%	2.1%
Margin percentage point change	**(.71)**	.13	(.19)
Average per-store merchandise sales	**5.2%**	1.9%	2.7%

The improvement in 1998 total merchandise gross profit dollars, compared to 1997, was due to a combination of higher per-store sales and more stores, as the margin percentage decreased 71 basis points. Total merchandise gross profit dollars increased in 1997 from both higher average per-store sales and a higher margin.

Merchandise margin declined in 1998 primarily due to product cost increases and continuing refinement of the Company's everyday-fair-pricing strategy. Merchandise margin was also impacted by introductory costs associated with new product offerings, combined with the further rollout of the Company's fresh food initiatives into four new markets. More aggressive retail pricing continues to present a challenge in today's increasingly more competitive environment. Although overall merchandise margin declined, several categories impacted margin favorably, including Café Cooler, commissions/services and coffee. Management is actively working to improve merchandise margin while providing fair and consistent prices.

The increase in merchandise margin in 1997 was primarily due to improved sales in some higher-margin categories like Slurpee, coffee, non-carbonated beverages and services. These increases were partially offset by higher write-offs, as the Company focused on expanding its fresh-food program, both geographically and with new products.

Cigarettes currently contribute nearly 22% of the Company's total merchandise sales and more than 15% of merchandise gross profit. With the recent and pending legal settlements between cigarette manufacturers and several state governments, as well as potential additional taxes and litigation threatened by the federal government, the Company anticipates that the cost of cigarettes could continue to rise. Additionally, there are numerous examples of pending state and federal legislation aimed at reducing minors' consumption of tobacco products, which include significant increases in cigarette taxes. Although the Company expects merchandise margin percent to be negatively impacted by these price increases, it is impossible to predict the impact potential cost increases could have on the Company's gross profit dollars, due to uncertainties regarding competitors' reactions and consumers' buying habits.

Gasoline Gross Profit Data

Years Ended December 31	1998	1997	1996
Gasoline Gross Profit — dollars in millions	**$ 208.0**	$ 183.8	$ 188.1
Gross profit margin (in cents per gallon)	**13.48**	13.07	13.45
Increase/(decrease) from prior year — all stores			
Average per-store gross profit dollar change	**7.5%**	(3.5)%	(1.4)%
Margin point change (in cents per gallon)	**.41**	(.38)	(.17)
Average per-store gas gallonage	**4.2%**	(.7)%	(.1)%

Gasoline gross profits improved $24.3 million in 1998 over 1997. This improvement was due to more gas stores, higher average per-store gas gallonage and a favorable change in cents-per-gallon gross profit. In general, 1998 market conditions created a situation where the wholesale cost of gasoline was significantly lower than in either 1997 or 1996. These conditions helped ease the competitive pressures that had been narrowing margins over the previous two years.

In 1997, gasoline gross profits declined $4.4 million from the levels achieved in 1996. Excluding the stores on the West Coast, the Company's gasoline gross profits increased $1.2 million in 1997 compared to 1996. This increase was comprised of a slight improvement in average

per-store gallons and an increase in the number of gas stores. The stores on the West Coast (24% of the Company's total gas stores) were impacted by industry product supply problems and intense competitive conditions, creating a situation where, in some cases, the Company's cost exceeded other operators' retail price of gasoline.

Operating, Selling, General and Administrative Expenses ("OSG&A")

(Dollars in Millions)

Years Ended December 31	1998	1997	1996
Total operating, selling, general and administrative expenses	**$ 2,053.8**	$ 1,896.2	$ 1,841.2
Ratio of OSG&A to sales	**28.3%**	27.2%	26.8%
Increase/(decrease) in OSG&A compared to prior year	**$ 157.6**	$ 55.0	$ (33.3)

The ratio of OSG&A expenses to sales increased 1.1 percentage points in 1998, compared to 1997. This increase is primarily due to a decline of 18 cents per gallon in 1998's retail price of gasoline. Adjusting for comparable gasoline prices, the ratio of OSG&A to sales was flat, when compared to 1997.

The increase in 1998 OSG&A expense over 1997 levels was partially due to charges of $14.1 million associated with write-offs of computer equipment and development costs and $7.6 million in severance and related costs. Other factors impacting OSG&A were increased store labor cost, a higher amount of gross profits shared with the franchisees (due to higher gross profits earned by franchisees), costs associated with operating additional stores and more environmental expenses. In addition, OSG&A expenses increased due to the Company's implementation of its retail information system and other strategic initiatives. Expenses associated with the Company's retail information system were approximately $13 million higher in 1998 than in 1997. While the ratio of OSG&A expenses to sales will vary on a quarterly basis, management believes this ratio will not improve significantly during the rollout phase of the retail information system.

The increase in OSG&A expenses, and the ratio to sales, in 1997 compared to 1996, was primarily the result of the following factors: incremental costs related to the retail information system initiatives; higher store labor cost due to a tight labor market and increases in the minimum wage rate; more depreciation expense due to the extensive remodeling program completed in late 1996, completion of new stores and other initiatives; more environmental remediation; and higher store insurance due to the comparison with favorable claims experience reflected in 1996.

The Company continues to review the functions necessary to enable its stores to respond faster and more cost efficiently to rapidly changing customer needs and preferences. In conjunction with this review, management continues to realign and reduce personnel in order to eliminate non-essential costs, while devoting resources to the implementation of its retail information system and other strategic initiatives (see Management Strategies). During 1998, accruals of $7.6 million were made representing severance benefits for close to 120 management and administrative employees whose positions have been, or will be terminated. The benefit from these reductions on an annualized basis approximates the charge, with the majority of the benefit carrying forward to future years.

The Company is a defendant in two legal actions, which are referred to as the 7-Eleven OFFF and Valente cases, filed by franchisees in 1993 and 1996, respectively, asserting various claims against the Company. A nationwide settlement was negotiated and, in connection with the settlement, these two cases have been combined on behalf of a class of all persons who operated 7-Eleven convenience stores in the United States at any time between January 1, 1987 and July 31, 1997, under franchise agreements with the Company. Class members have overwhelmingly approved the settlement, and the court presiding over the settlement process gave its final approval of the settlement on April 24, 1998. The settlement provides that former franchisees will share in a settlement fund and that certain changes will be made to the franchise agreements with current franchisees.

Notices of appeal of the order approving the settlement were filed on behalf of three of the attorneys who represented the class, six former franchisees and two current franchisees. One of these current franchisees has dismissed his appeal. The settlement agreement will not become effective until the appeals are resolved. However, the settlement agreement provides that while the appeals are pending the Company will pay certain maintenance and supply expenses relating to the cash registers and retail information system equipment of current franchisees that are members of the settlement class. If the settlement is overturned on appeal, the Company has the right to require franchisees to repay the amounts that the Company paid for these expenses while the appeals were pending. The Company's payment of these expenses had no material impact on 1998 earnings and should have no material impact on future earnings. The Company's accruals are sufficient to cover the total settlement costs, including the payment due to former franchisees when the settlement becomes effective.

Interest Expense, Net

Net interest expense increased $1.2 million in 1998, compared to 1997. This increase is primarily due to a higher average debt balance in 1998, combined with the redemption of a portion of the Company's public debt securities (see Extraordinary Gain) which were accounted for under SFAS No. 15 (see discussion below), partially offset by the write-off of deferred costs associated with the Company's refinancing of its credit agreement in February 1997.

Approximately 43% of the Company's debt contains floating rates that will be unfavorably impacted by rising interest rates. Nearly 30% of the Company's floating rate debt exposure to rising interest rates has been eliminated as a result of an interest rate swap agreement (see Interest Rate Swap Agreement). The weighted-average interest rate for such debt, including the impact of the interest rate swap agreement, was 5.7% for 1998 versus 5.8% for both 1997 and 1996.

The Company expects net interest expense in 1999 to increase approximately 10% over 1998 based on anticipated levels of debt and interest rate projections. Factors increasing 1999 interest expense include higher borrowings to finance new store development and other initiatives, combined with the redemption of $65 million of the Company's public debt securities in 1998 and early 1999, which were accounted for under SFAS No. 15 (see Extraordinary Gain).

In accordance with SFAS No. 15, no interest expense is recognized on the Company's public debt securities. These securities were recorded at an amount equal to the future undiscounted cash payments, both principal and interest, and accordingly, the cash interest payments are charged against the recorded amount of such securities and are not treated as interest expense. Accordingly, interest expense on debt used to redeem public debt securities would increase the Company's reported interest expense.

Net interest expense decreased slightly in 1997 compared to 1996 due to lower average borrowing throughout the year, partially offset by lower interest income. The lower interest income was primarily the result of a new money order agreement in 1996 that eliminated interest income from the funding arrangement; however, it provided lower cost of goods and operating costs, which more than offset the impact of the lost interest.

Interest Rate Swap Agreement

In June 1998, the Company entered into an interest rate swap agreement that fixed the interest rate on $250 million notional principal amount of existing floating rate debt at 5.4% through June 2003. A major financial institution, as counterparty to the agreement, agreed to pay the Company a floating interest rate based on three-month LIBOR during the term of the agreement in exchange for the Company paying a fixed interest rate. The impact on net interest expense for the fourth quarter and for 1998 was nominally favorable as a result of this agreement. The swap agreement granted the counterparty the option, upon expiration of the initial swap term, of extending the agreement for an additional five years at a fixed interest rate of 5.9%. This option component of the agreement was recognized at fair value and was marked to market. Due to declining interest rates, the Company recognized OSG&A expense related to the option component of $0.5 million in the fourth quarter and $3.7 million for 1998.

In February 1999, the Company amended the terms of the interest rate swap agreement. The fixed rate was increased to 6.1% and the term of the swap was extended to February 2004; the remaining terms of the swap agreement were unchanged. In exchange for the increase in the fixed rate, the five-year extension option held by the counterparty was terminated.

Income Taxes

The Company recorded tax expense in 1998 from earnings before extraordinary gain of $31.9 million, compared to expense of $45.3 million in 1997 and $41.3 million in 1996. The decrease in 1998 income tax expense, compared to 1997, resulted from lower earnings before tax, in large part due to charges discussed in the Summary of Results of Operations section. The 1998 extraordinary gain was net of $14.9 million of tax expense. Higher income tax expense in 1997, when compared to 1996, was due to a settlement of an IRS tax examination, resulting in a $7.3 million tax benefit in 1996.

Extraordinary Gain

During 1998, the Company redeemed $45.6 million of its public debt securities resulting in a $23.3 million after-tax gain. The gain resulted from the retirement of future undiscounted interest payments as recorded under SFAS No. 15, combined with repurchasing a portion of the debentures below their face amount. As a result of the redemptions, the face amount of the debentures has been reduced by the following: 100% of the 12% Second

Priority Senior Subordinated Debentures, 5.8% of the 5% First Priority Senior Subordinated Debentures, 6.3% of the 4.5% Second Priority Senior Subordinated Debentures-Series A and 1.3% of the 4% Second Priority Senior Subordinated Debentures-Series B. The Company's cash outlay, including fees, was $42.2 million, which was financed through the issuance of $80 million of 4½% Convertible Quarterly Income Debt Securities ("1998 QUIDS") due 2013. The 1998 QUIDS were issued to Ito-Yokado Co., Ltd. and Seven-Eleven Japan Co., Ltd., the joint owners of IYG Holding Company, the Company's majority shareholder.

In the first quarter of 1999, the Company redeemed an additional $19.4 million of its public debt securities resulting in a $4.3 million after-tax gain.

LIQUIDITY AND CAPITAL RESOURCES

The majority of the Company's working capital is provided from three sources: i) cash flows generated from its operating activities; ii) a $650 million commercial paper facility (guaranteed by Ito-Yokado Co., Ltd.); and iii) short-term seasonal borrowings of up to $400 million (reduced by outstanding letters of credit) under its revolving credit facility. The Company believes that operating activities, coupled with available short-term working capital facilities, will provide sufficient liquidity to fund current commitments for operating and capital expenditure programs, as well as to service debt requirements. Actual capital expenditure funding will be dependent on the level of cash flow generated from operating activities and the funds available from financings.

In January 1999, the Company expanded the existing commercial paper facility from $400 million to $650 million. The commercial paper is unsecured but is fully and unconditionally guaranteed by Ito-Yokado Co., Ltd.

In April 1998, the Company entered into a financing agreement for 12.5 billion yen, or $96.5 million, monetizing a portion of its future yen royalty stream. The financing, which bears interest at 2.325%, is secured by a pledge (secondary to the 1988 yen-denominated loan) of the future royalty payments from Seven-Eleven Japan associated with the Company's Japanese 7-Eleven trademarks. Payment of principal and interest on the debt is non-recourse to the Company and will commence when the 1988 yen-denominated loan is paid in full, which is currently estimated to be in 2001. It is anticipated that this 1998 loan will be fully repaid in 2006.

In February 1998, the Company issued $80 million of 1998 QUIDS, which is subordinated to all existing debt except the 1995 Convertible Quarterly Income Debt Securities due 2010, which have the same priority ranking. The debt has a 15-year life, no amortization and an interest rate of 4.5%. The instrument gives the Company the right to defer interest payments thereon for up to 20 consecutive quarters. The debt mandatorily converts into 32,508,432 shares of the Company's common stock if the price of the Company's common stock achieves certain levels after the third anniversary of issuance. A portion of the proceeds from the 1998 QUIDS was used to redeem a portion of the Company's public debt securities.

Southland's credit agreement, established in February 1997, includes a $225 million term loan and a $400 million revolving credit facility, which has a sublimit of $150 million for letters of credit ("Credit Agreement"). The Credit Agreement contains certain financial and operating covenants requiring, among other things, the maintenance of certain financial ratios, including interest and rent coverage, fixed-charge coverage and senior indebtedness to net earnings before extraordinary items and interest, taxes, depreciation and amortization ("EBITDA"). The covenant levels established by the Credit Agreement generally require continuing improvement in the Company's financial condition. In March 1999, the financial covenant levels required by these instruments were amended prospectively in order to allow the Company flexibility to continue its store growth strategy. In connection with this amendment, the interest rate on borrowings was changed to a reserve-adjusted Eurodollar rate plus .475% instead of the previous increment of .225%.

For the period ended December 31, 1998, the Company was in compliance with all of the covenants required under the Credit Agreement, including compliance with the principal financial and operating covenants under the Credit Agreement (calculated over the latest 12-month period) as follows:

Covenants	Actuals	Requirements Minimum	Requirements Maximum
Interest and rent coverage*	2.08 to 1.0	1.80 to 1.0	
Fixed charge coverage	1.67 to 1.0	1.50 to 1.0	
Senior indebtedness to EBITDA	3.74 to 1.0		4.10 to 1.0
Capital expenditure limit (tested annually)	$413 million		$425 million

** Includes effects of the SFAS No 15 interest payments not recorded in interest expense.*

In 1998, the Company repaid $196.5 million of debt of which $42.1 million related to the redemption of the Company's subordinated debentures (see Extraordinary Gain) and $10.9 million was for debt assumed in the Christy's acquisition (see Capital Expenditures — Acquisitions). The remaining principal reduction of $143.5 million included $56.3 million for quarterly installments due on the term loan, $40.9 million for principal payments on the Company's yen-denominated loan (secured by the royalty income stream from SEJ), $20.5 million for

SFAS No. 15 interest and $20.4 million on capital leases. Outstanding balances at December 31, 1998, for commercial paper, term loan and revolver, were $368.3 million, $168.8 million and $295.0 million, respectively. As of December 31, 1998, outstanding letters of credit issued pursuant to the Credit Agreement totaled $71.1 million.

Cash from Operating Activities

Net cash provided by operating activities was $232.8 million for 1998, compared to $197.9 million in 1997 and $261.0 million in 1996. Contributing to the decline in cash provided by operating activities in 1997, when compared to 1996, was an increase in inventories, caused by a December 1997 cigarette buy-in and generally higher per-store inventory levels.

Capital Expenditures

In 1998, net cash used in investing activities consisted primarily of payments of $380.9 million for property and equipment and $32.9 million for acquisitions (see Capital Expenditures — Acquisitions). The majority of the property and equipment capital was used for new store development, continued implementation of the Company's retail information system, remodeling stores, new equipment to support merchandising initiatives, upgrading retail gasoline facilities, replacing equipment and complying with environmental regulations.

The Company expects 1999 capital expenditures, excluding lease commitments, to exceed $375 million. Capital expenditures are being used to develop or acquire new stores, upgrade store facilities, further implement a retail information system, replace equipment, upgrade gasoline facilities and comply with environmental regulations. The amount of expenditures during the year will be materially impacted by the proportion of new store development funded through capital expenditures versus leases and the speed at which new sites/acquisitions can be located, negotiated, permitted and constructed.

Capital Expenditures — Acquisitions

In May 1998, the Company purchased all of the capital stock of Christy's Market, Inc., of Brockton, Mass., thereby acquiring 135 Christy's Market convenience stores, located in the New England area. Also in May 1998, the Company purchased the assets of 20 'red D mart' convenience stores in the South Bend, Indiana, area from MDK Corporation of Goshen, Indiana.

Capital Expenditures — Gasoline Equipment

The Company incurs ongoing costs to comply with federal, state and local environmental laws and regulations primarily relating to underground storage tank ("UST") systems. The Company does not anticipate any 1999 capital improvements required to comply with environmental regulations relating to USTs as well as above-ground vapor recovery equipment at store locations, but will spend approximately $15-20 million on such capital improvements from 2000 through 2002.

Environmental

In December 1988, the Company closed its chemical manufacturing facility in New Jersey. The Company is required to conduct environmental remediation at the facility, including groundwater monitoring and treatment for a projected 15-year period. The remediation program will commence in 1999 with the performance of certain engineering and design work. The Company has recorded undiscounted liabilities representing its best estimates of the clean-up costs of $8.7 million at December 31, 1998. In 1991, the Company and the former owner of the facility entered into a settlement agreement pursuant to which the former owner agreed to pay a substantial portion of the clean-up costs. Based on the terms of the settlement agreement and the financial resources of the former owner, the Company has a receivable recorded of $5.1 million at December 31, 1998.

Additionally, the Company accrues for the anticipated future costs and the related probable state reimbursement amounts for remediation activities at its existing and previously operated gasoline sites where releases of regulated substances have been detected. At December 31, 1998, the Company's estimated undiscounted liability for these sites was $41.9 million. This estimate is based on the Company's prior experience with gasoline sites and its consideration of such factors as the age of the tanks, location of tank sites and experience with contractors who perform environmental assessment and remediation work. The Company anticipates that substantially all of the future remediation costs for detected releases at these sites as of December 31, 1998, will be incurred within the next four to five years.

Under state reimbursement programs, the Company is eligible to receive reimbursement for a portion of future remediation costs, as well as a portion of remediation costs previously paid. Accordingly, at December 31, 1998, the Company has recorded a net receivable of $46.7 million for the estimated probable state reimbursements. In assessing the probability of state reimbursements, the Company takes into consideration each state's fund balance, revenue sources, existing claim backlog, status of clean-up activity and claim ranking systems. As a result of these assessments, the recorded receivable amount is net of an allowance of $10.0 million. While there is no assurance of the timing of the receipt of state reimbursement funds, based on its experience, the Company expects to receive the majority of state reimbursement funds, except

from California, within one to three years after payment of eligible remediation expenses, assuming that the state administrative procedures for processing such reimbursements have been fully developed. The Company estimates that it may take one to six years to receive reimbursement funds from California. Therefore, the portion of the recorded receivable amount that relates to sites where remediation activities have been conducted has been discounted at 4.6% to reflect their present value. Thus, the recorded receivable amount is also net of a discount of $4.1 million.

The estimated future assessment and remediation expenditures and related state reimbursement amounts could change within the near future as governmental requirements and state reimbursement programs continue to be implemented or revised.

Environmental — Acquisitions

Both the 'red D mart' and Christy's Market acquisitions include retail gasoline outlets that are subject to certain environmental regulations. Under the terms of the acquisition agreements, the sellers are responsible for ensuring compliance with all applicable environmental regulations existing as of the closing date. In addition, the acquisition agreements provide that the sellers will remain responsible for the expense of any future environmental cleanup, which is required under applicable legal requirements and which results from conditions existing at the sites (see Capital Expenditures — Acquisitions).

Year 2000

The Year 2000 issue ("Y2K") is the result of computer software programs being coded to use two digits rather than four to define the applicable year. Some of the Company's older computer programs that have date-sensitive coding may recognize a date using "00" as the year 1900 rather than the year 2000. This could result in system failures or miscalculations, causing disruptions of operations.

The Company has approached the Y2K issue in phases. A Year 2000 Project Office Manager, together with a strong support organization, has designed a Y2K work plan that is currently being implemented. The Y2K work plan includes: (1) identifying and inventorying all Year 2000 tasks and items; (2) assigning priorities to all tasks and items; (3) remediation of information systems ("IS") applications code, testing and reintegration to production, as well as testing all replaced systems, software and non-remediated applications; (4) contacting third-party vendors to verify their compliance and perform selected interface tests with major vendors; (5) determining the Company's Y2K responsibilities to its franchisees, subsidiaries and affiliates; (6) establishing contingency alternatives assuming worst-case scenarios.

The Company continues to progress favorably in its completion of the various tasks and target dates identified in the Y2K work plan. The Company believes it has identified and prioritized all major Y2K-related items. In addition, numerous non-IS, merchandise, equipment, financial institution, insurance and public utility vendors have been contacted, inquiring as to their readiness and the readiness of their respective vendors. At this time the Company is performing follow-up efforts with the above vendors as required. Testing compliance with major vendors is now being planned and scheduled to begin June 1, 1999. The following reflects management's assessment of the Company's Year 2000 state of readiness:

State of Readiness as of December 31, 1998

Phase	Estimated Percent Complete	Estimated Completion Date
Internal IS and Non-IS Systems and Equipment:		
Awareness	98%	Dec. 1999*
Assessment changes required	95%	March 1999
Remediation or replacement	85%	June 1999
Testing	20%	Sept. 1999
Contingency Planning	15%	June 1999*
Suppliers, Customers and Third-Party Providers:		
Awareness — Identify companies	95%	April 1999
Assessment questionnaire completed by major suppliers	60%	May 1999*
Assessment review with 3rd-party providers	25%	May 1999
Review contractual commitments	40%	June 1999
Risk Assessment	50%	May 1999
Contingency Planning	5%	June 1999*
Testing as applicable	5%	Sept. 1999

** Indicates work should be significantly finished at the estimated completion date, but the Company will continue to reevaluate awareness, send follow-up questionnaires and update contingency plans as needed.*

The Company estimates that the cost of the Year 2000 Project will be approximately $7-8 million, of which about $3 million will be capital costs. The costs incurred to date are $1 million, with the remaining cost for outside consultants, software and hardware applications to be funded through operating cash flow. This estimate includes costs related to the upgrade and/or replacement of computer software and hardware; costs of remediated code testing and test result verification; and the reintegration to production of all remediated applications.

In addition, the costs include the testing of applications and software currently certified as Year 2000 compliant. The Company does not separately track the internal costs incurred for the Y2K project, which are primarily the related payroll costs for the IS and various user personnel participating in the project.

Due to the general uncertainty inherent in the Year 2000 process, primarily due to issues surrounding the Y2K readiness of third-party suppliers and vendors, a reasonable worst-case scenario is difficult to determine at this time. The Company does not anticipate more than temporary isolated disruptions attributed to Year 2000 issues to affect either the Company or its primary vendors. The Company is concentrating on four critical business areas in order to identify, evaluate and determine the scenarios requiring the development of contingency plans: (1) merchandise ordering and receipt, (2) petroleum products ordering and receipt, (3) human resource systems and (4) disbursement systems. To the extent vendors are unable to deliver products due to their own Year 2000 issues, the Company believes it will generally have alternative sources for comparable products and does not expect to experience any material business disruptions. Although considered unlikely, the failure of public utility companies to provide telephone and electrical service could have material consequences. Contingency planning efforts will escalate as the Company continues to receive and evaluate responses from all of its primary merchandise vendors and service providers. These contingency plans are scheduled to be complete by June 1999.

The costs of the Y2K project and the date on which the Company plans to complete the Year 2000 modifications are based on management's best estimates, which were derived utilizing numerous assumptions of future events including the continued availability of certain resources, third-party modification plans and other factors. As a result, there can be no assurance that these forward-looking estimates will be achieved and the actual costs and vendor compliance could differ materially from the Company's current expectations, resulting in a material financial risk. In addition, while the Company is making significant efforts in addressing all anticipated Year 2000 risks within its control, this event is unprecedented and consequently there can be no assurance that the Year 2000 issue will not have a material adverse impact on the Company's operating results and financial condition.

Market-Sensitive Instruments and Risk Management

The following discussion summarizes the financial and derivative instruments held by the Company at December 31, 1998, which are sensitive to changes in interest rates, foreign exchange rates and equity prices. The Company uses interest-rate swaps to manage the primary market exposures associated with underlying liabilities and anticipated transactions. The Company uses these instruments to reduce risk by essentially creating offsetting market exposures. In addition, the two yen-denominated loans serve to effectively hedge the Company's exposure to yen-dollar currency fluctuations. The instruments held by the Company are not leveraged and are held for purposes other than trading. There are no material quantitative changes in market risk exposure at December 31, 1998, when compared to December 31, 1997.

In the normal course of business, the Company also faces risks that are either nonfinancial or nonquantifiable. Such risks principally include country risk, credit risk and legal risk and are not represented in this discussion.

Interest-Rate Risk Management

The table on the following page presents descriptions of the floating-rate financial instruments and interest-rate-derivative instruments held by the Company at December 31, 1998. The Company entered into an interest-rate swap to achieve the appropriate level of variable and fixed-rate debt as approved by senior management. Under the interest-rate swap, the Company agreed with other parties to exchange the difference between fixed-rate and floating-rate interest amounts on a quarterly basis.

For the debt, the table on the following page presents principal cash flows that exist by maturity date and the related average interest rate. For the swap, the table presents the notional amounts outstanding and expected interest rates that exist by contractual dates. The notional amount is used to calculate the contractual payments to be exchanged under the contract. The variable rates are estimated based on implied forward rates in the yield curve at the reporting date. Additionally, the interest rate on the bank debt reflects a LIBOR margin of 22.5 basis points as prescribed in the Credit Agreement.

(Dollars in Millions)	1999	2000	2001	2002	2003	There-after	Total	Fair Value
Floating-Rate Financial Instruments:								
Bank debt	$ 56	$ 56	$ 56	$ 295	$ 0	$ 0	$ 463	$ 463
Commercial paper	$ 18	$ 0	$ 0	$ 0	$ 0	$ 350	$ 368	$ 368
Average interest rate	5.2%	5.2%	5.3%	5.2%	5.3%	5.4%	5.2%	
Interest-Rate Derivatives:								
Notional amount	$ 250	$ 250	$ 250	$ 250	$ 250	$ 250	$ 250	$ (11)
Average pay rate	6.1%	6.1%	6.1%	6.1%	6.1%	6.1%	6.1%	
Average receive rate	5.1%	5.2%	5.2%	5.3%	5.3%	5.4%	5.3%	

The $11 million fair value of the interest-rate swap represents an estimate of the payment amount if the Company chose to terminate the swap. See Notes 9 and 10 to the Consolidated Financial Statements for detailed information on both floating- and fixed-rate liabilities. See Note 11 to the Consolidated Financial Statements for fair value and derivative discussions, including the mark-to-market adjustment relating to the unwinding of the swap's option component in February 1999.

Foreign-Exchange Risk Management
The Company recorded over $68 million in royalty income in 1998 that was impacted by fluctuating exchange rates. Approximately 77% of such royalties were from area license agreements with SEJ. SEJ royalty income will not fluctuate with exchange rate movements since the Company has effectively hedged this exposure by using the royalty income to make principal and interest payments on its yen-denominated loans (see Notes 9 and 11 to the Consolidated Financial Statements). The Company is exposed to fluctuating exchange rates on the non-SEJ portion of its royalties earned in foreign currency, but based on current estimates, future risk is not material.

The Company has several wholly or partially owned foreign subsidiaries and is susceptible to exchange-rate risk on earnings from these subsidiaries. Based on current estimates, the Company does not consider future foreign-exchange risk associated with these subsidiaries to be material.

Equity-Price Risk Management
The Company has equity securities, which are classified as available for sale and are carried in the Consolidated Balance Sheet at fair value. Changes in fair value are recognized as other comprehensive earnings, net of tax, as a separate component of shareholders' equity. At December 31, 1998, the Company held the following available-for-sale marketable equity securities:

(Dollars in Millions)	Cost	Fair Value	Impact of 20% Change in Market Price
568,788 shares of ACS common stock	$ 0	$ 25.6	$ 5.1
151,452 shares of Precept common stock	$ 0	$ 1.4	$ 0.3

The Affiliated Computer Services, Inc. stock ("ACS") was obtained in 1988 as partial consideration for Southland to enter into a mainframe data processing contract with ACS. At the time, ACS was a privately held start-up company and accordingly the stock was valued with no cost. Subsequently ACS became a public company and Precept Business Services, Inc. ("Precept") was spun off from ACS and also became a public company.

(Dollars in Thousands, Except Per-Share Data)

December 31	1998	1997
ASSETS		
Current assets:		
Cash and cash equivalents	$ 26,880	$ 38,605
Accounts receivable	148,046	126,495
Inventories	101,045	104,540
Other current assets	162,631	117,001
Total current assets	438,602	386,641
Property and equipment	1,652,932	1,416,687
Other assets	324,310	286,753
	$ 2,415,844	$ 2,090,081
LIABILITIES AND SHAREHOLDERS' EQUITY (DEFICIT)		
Current liabilities:		
Trade accounts payable	$ 136,059	$ 118,222
Accrued expenses and other liabilities	362,398	353,844
Commercial paper	18,348	48,744
Long-term debt due within one year	151,754	208,839
Total current liabilities	668,559	729,649
Deferred credits and other liabilities	220,653	187,414
Long-term debt	1,788,843	1,594,545
Convertible quarterly income debt securities	380,000	300,000
Commitments and contingencies		
Shareholders' equity (deficit):		
Common stock, $.0001 par value; 1,000,000,000 shares authorized; 409,922,935 shares issued and outstanding	41	41
Additional capital	625,574	625,574
Accumulated deficit	(1,278,009)	(1,352,057)
Accumulated other comprehensive earnings	10,183	4,915
Total shareholders' equity (deficit)	(642,211)	(721,527)
	$ 2,415,844	$ 2,090,081

See notes to consolidated financial statements

(Dollars in Thousands, Except Per-Share Data)

Years Ended December 31	1998	1997	1996
Revenues:			
Merchandise sales (including $466,013, $438,489 and $437,573 in excise taxes)	**$ 5,573,606**	$ 5,181,762	$ 5,084,024
Gasoline sales (including $577,457, $532,635 and $524,414 in excise taxes)	**1,684,184**	1,789,383	1,784,888
Net sales	**7,257,790**	6,971,145	6,868,912
Other income	**92,021**	89,412	86,351
	7,349,811	7,060,557	6,955,263
Costs and expenses:			
Merchandise cost of goods sold	**3,645,974**	3,353,323	3,296,316
Gasoline cost of goods sold	**1,476,144**	1,605,603	1,596,745
Total cost of goods sold	**5,122,118**	4,958,926	4,893,061
Operating, selling, general and administrative expenses	**2,053,791**	1,896,206	1,841,174
Interest expense, net	**91,289**	90,130	90,204
	7,267,198	6,945,262	6,824,439
Earnings before income taxes and extraordinary gain	**82,613**	115,295	130,824
Income taxes	**31,889**	45,253	41,348
Earnings before extraordinary gain	**50,724**	70,042	89,476
Extraordinary gain on debt redemption (net of tax effect of $14,912)	**23,324**	—	—
Net earnings	**$ 74,048**	$ 70,042	$ 89,476
Earnings before extraordinary gain per common share:			
Basic	**$ .12**	$ .17	$ .22
Diluted	**.12**	.16	.20
Extraordinary gain on debt redemption per common share:			
Basic	**$ .06**	$ —	$ —
Diluted	**.05**	—	—
Net earnings per common share:			
Basic	**$ .18**	$ .17	$ .22
Diluted	**.17**	.16	.20

See notes to consolidated financial statements.

(Dollars in Thousands, Except Share Amounts)

Years Ended December 31	1998 Ending Balance	1998 Activity	1997 Ending Balance	1997 Activity	1996 Ending Balance	1996 Activity	1996 Beginning Balance
Common stock shares issued and outstanding	**409,922,935**	**—**	409,922,935	—	409,922,935	—	409,922,935
Common stock, $.0001 par value	**$ 41**	**$ —**	$ 41	$ —	$ 41	$ —	$ 41
Additional capital	**625,574**	**—**	625,574	—	625,574	—	625,574
Accumulated earnings (deficit)	**(1,278,009)**	**74,048**	(1,352,057)	70,042	(1,422,099)	89,476	(1,511,575)
Accumulated other comprehensive earnings:							
Foreign Currency Translation (Activity net of ($1,255), ($672), ($167) income tax benefit)	**(6,273)**	**(1,997)**	(4,276)	(1,040)	(3,236)	(258)	(2,978)
Unrealized Gain (Loss) on Equity Securities (Activity net of $4,645, ($1,006), $1,674 deferred taxes)	**16,456**	**7,265**	9,191	(1,574)	10,765	2,619	8,146
Total accumulated other comprehensive earnings (loss)	**10,183**	**5,268**	4,915	(2,614)	7,529	2,361	5,168
Accumulated comprehensive earnings (loss)	**(1,267,826)**	**79,316**	(1,347,142)	67,428	(1,414,570)	91,837	(1,506,407)
Total shareholders' equity (deficit)	**$ (642,211)**	**$ 79,316**	$ (721,527)	$ 67,428	$ (788,955)	$ 91,837	$ (880,792)

See notes to consolidated financial statements

(Dollars in Thousands)

Years Ended December 31	1998	1997	1996
Cash flows from operating activities:			
Net earnings	$ **74,048**	$ 70,042	$ 89,476
Adjustments to reconcile net earnings to net cash provided by operating activities:			
Extraordinary gain on debt redemption	**(23,324)**	—	—
Depreciation and amortization of property and equipment	**175,086**	177,174	166,347
Other amortization	**19,611**	19,026	19,026
Deferred income taxes	**19,190**	31,812	23,790
Noncash interest expense	**1,725**	2,342	1,746
Other noncash expense	**4,557**	96	182
Net loss on property and equipment	**9,631**	2,391	1,714
(Increase) decrease in accounts receivable	**(29,428)**	(6,560)	4,824
Decrease (increase) in inventories	**11,306**	(16,010)	(4,046)
Increase in other assets	**(28,576)**	(6,117)	(2,598)
Decrease in trade accounts payable and other liabilities	**(1,014)**	(76,250)	(39,421)
Net cash provided by operating activities	**232,812**	197,946	261,040
Cash flows from investing activities:			
Payments for purchase of property and equipment	**(380,871)**	(232,539)	(194,373)
Proceeds from sale of property and equipment	**8,607**	39,648	14,499
Increase in restricted cash	**(22,810)**	—	—
Acquisition of businesses, net of cash acquired	**(32,929)**	—	—
Other	**8,379**	6,908	9,588
Net cash used in investing activities	**(419,624)**	(185,983)	(170,286)
Cash flows from financing activities:			
Proceeds from commercial paper and revolving credit facilities	**7,231,795**	5,907,243	4,292,215
Payments under commercial paper and revolving credit facilities	**(7,032,120)**	(5,842,539)	(4,249,134)
Proceeds from issuance of long-term debt	**96,503**	225,000	—
Principal payments under long-term debt agreements	**(196,477)**	(299,005)	(140,388)
Proceeds from issuance of convertible quarterly income debt securities	**80,000**	—	—
Other	**(4,614)**	(551)	—
Net cash provided by (used in) financing activities	**175,087**	(9,852)	(97,307)
Net (decrease) increase in cash and cash equivalents	**(11,725)**	2,111	(6,553)
Cash and cash equivalents at beginning of year	**38,605**	36,494	43,047
Cash and cash equivalents at end of year	$ **26,880**	$ 38,605	$ 36,494
Related disclosures for cash flow reporting:			
Interest paid, excluding SFAS No. 15 Interest	$ **(99,240)**	$ (97,568)	$ (100,777)
Net income taxes paid	$ **(11,721)**	$ (10,482)	$ (18,918)
Assets obtained by entering into capital leases	$ **33,643**	$ 56,745	$ 3,761

See notes to consolidated financial statements.

Years Ended December 31, 1998, 1997 and 1996
(Dollars in thousands, except per-share data)

1. ACCOUNTING POLICIES

Principles of Consolidation — The Southland Corporation and subsidiaries ("the Company") is owned approximately 65% by IYG Holding Company, which is jointly owned by Ito-Yokado Co., Ltd. ("IY") and Seven-Eleven Japan Co., Ltd. ("SEJ"). The Company operates more than 5,600 7-Eleven and other convenience stores in the United States and Canada. Area licensees, or their franchisees, and affiliates operate approximately 12,600 additional 7-Eleven convenience stores in certain areas of the United States, in 16 foreign countries and in the U.S. territories of Guam and Puerto Rico.

The consolidated financial statements include the accounts of The Southland Corporation and its subsidiaries. Intercompany transactions and account balances are eliminated. Prior-year and quarterly amounts have been reclassified to conform to the current-year presentation.

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and revenues and expenses during the reporting period. Actual results could differ from those estimates.

Merchandise and gasoline sales and cost of goods sold of stores operated by franchisees are consolidated with the results of Company-operated stores. Merchandise and gasoline sales of stores operated by franchisees are $3,034,951, $2,880,148 and $2,860,768 from 2,960, 2,868 and 2,927 stores for the years ended December 31, 1998, 1997 and 1996, respectively.

The gross profit of the franchise stores is split between the Company and its franchisees. The Company's share of the gross profit of franchise stores is its continuing franchise fee, generally ranging from 50% to 58% of the merchandise gross profit of the store, which is charged to the franchisee for the license to use the 7-Eleven operating system and trademarks, for the lease and use of the store premises and equipment, and for continuing services provided by the Company. These services include merchandising, advertising, recordkeeping, store audits, contractual indemnification, business counseling services and preparation of financial summaries. In addition, franchisees receive the greater of one cent per gallon sold or 25% of gasoline gross profit as compensation for measuring and reporting deliveries of gasoline, conducting pricing surveys of competitors, changing the prices and cleaning the service areas. The total gross profit earned by the Company's franchisees of $551,003, $524,941 and $520,216 for the years ended December 31, 1998, 1997 and 1996, respectively, is included in the Consolidated Statements of Earnings as operating, selling, general and administrative expenses ("OSG&A").

Sales by stores operated under domestic and foreign area license agreements are not included in consolidated revenues. All fees or royalties arising from such agreements are included in other income. Initial fees, which have been immaterial, are recognized when the services required under the agreements are performed.

Operating Segment — As of January 1, 1998, the Company adopted the provisions of Statement of Financial Accounting Standards ("SFAS") No. 131, "Disclosures about Segments of an Enterprise and Related Information." SFAS No. 131 is effective for fiscal years beginning after December 15, 1997, and establishes standards for reporting information about a company's operating segments. It also establishes standards for related disclosures about products and services, geographic areas and major customers.

The Company operates in a single operating segment — the operating, franchising and licensing of convenience food stores, primarily under the 7-Eleven name. Revenues from external customers are derived principally from two major product categories — merchandise and gasoline. The Company's merchandise sales are comprised of groceries, beverages, tobacco products, beer/wine, candy/snacks, fresh foods, dairy products, non-food merchandise and services. Services include lottery, ATM and money order service fees/commissions for which there are little, if any, costs included in merchandise cost of goods sold.

The Company does not record merchandise sales on the basis of product categories. However, based on the total dollar volume of store purchases, management estimates that the percentages of its convenience store merchandise sales by principal product category for the last three years were as follows:

Product Categories

Years Ended December 31	1998	1997	1996
Beverages	**23.7%**	23.2%	22.6%
Tobacco Products	**23.7%**	22.5%	22.3%
Beer/Wine	**11.3%**	11.8%	12.2%
Candy/Snacks	**9.5%**	9.8%	9.8%
Non-Foods	**6.9%**	7.5%	7.6%
Food Service	**6.0%**	5.9%	5.8%
Dairy Products	**5.3%**	5.6%	5.8%
Customer Services	**4.8%**	4.4%	4.4%
Other	**4.6%**	4.9%	5.0%
Baked Goods	**4.2%**	4.4%	4.5%
Total Merchandise Sales	**100%**	100%	100%

The Company does not rely on any major customers as a source of revenue. Excluding area license royalties, which are included in other income as stated above, the

Company's operations are concentrated in the United States and Canada. Approximately 8% of the Company's net sales for the years ended December 31, 1998, 1997 and 1996 are from Canadian operations, and approximately 5% of the Company's long-lived assets for the years ended December 31, 1998 and 1997 are located in Canada.

Other Income — Other income is primarily area license royalties and franchise fee income. The area license royalties include amounts from area license agreements with SEJ of approximately $53 million, $50 million and $47 million for the years ended December 31, 1998, 1997 and 1996, respectively.

Under the present franchise agreements, initial franchise fees are generally calculated based on gross profit experience for the store or market area. These fees cover certain costs including training, an allowance for lodging for the trainees and other costs relating to the franchising of the store. The Company defers the recognition of these fees in income until its obligations under the agreement are completed. For the years ended December 31, 1998, 1997 and 1996, respectively, franchisee fee income was $11,881, $8,309 and $9,358.

Operating, Selling, General and Administrative Expenses — Buying and occupancy expenses are included in OSG&A. Advertising costs, also included in OSG&A, generally are charged to expense as incurred and were $40,144, $35,111 and $34,707 for the years ended December 31, 1998, 1997 and 1996, respectively.

Interest Expense — Interest expense is net of interest income of $12,021, $8,788 and $10,649 for the years ended December 31, 1998, 1997 and 1996, respectively.

Income Taxes — Income taxes are determined using the liability method, where deferred tax assets and liabilities are recognized for temporary differences between the tax basis of assets and liabilities and their reported amounts in the financial statements. Deferred tax assets include tax carryforwards and are reduced by a valuation allowance if, based on available evidence, it is more likely than not that some portion or all of the deferred tax assets will not be realized.

Cash and Cash Equivalents — The Company considers all highly liquid investment instruments purchased with maturities of three months or less to be cash equivalents. Cash and cash equivalents include temporary cash investments of $29,167 and $5,240 at December 31, 1998 and 1997, respectively, stated at cost, which approximates market.

Inventories — Inventories are stated at the lower of cost or market. Cost is generally determined by the LIFO method for stores in the United States and by the FIFO method for stores in Canada.

Depreciation and Amortization — Depreciation of property and equipment is based on the estimated useful lives of these assets using the straight-line method. Buildings and leaseholds are depreciated over periods generally ranging from five to twenty years, and equipment is generally depreciated over a three-to-ten-year period. Acquisition and development costs for significant business systems and related software for internal use are capitalized and are depreciated on a straight-line basis over a three-to-seven-year period based on their estimated useful lives. Amortization of capital leases, improvements to leased properties and favorable leaseholds is based on the remaining terms of the leases or the estimated useful lives, whichever is shorter.

Foreign and domestic area license royalty intangibles were recorded in 1987 at the fair value of future royalty payments and are being amortized over 20 years using the straight-line method. The 20-year life is less than the estimated lives of the various royalty agreements, the majority of which are perpetual. The excess of cost over fair value of net assets acquired is recorded as goodwill and amortized on a straight-line basis over 40 years.

Store Closings / Asset Impairment — Provision is made on a current basis for the write-down of identified owned-store closings to their net realizable value. For identified leased-store closings, leasehold improvements are written down to their net realizable value and a provision is made on a current basis if anticipated expenses are in excess of expected sublease rental income. The Company's long-lived assets, including goodwill, are reviewed for impairment and written down to fair value whenever events or changes in circumstances indicate that the carrying value may not be recoverable.

Insurance — The Company has established insurance programs to cover certain insurable risks consisting primarily of physical loss to property, business interruptions resulting from such loss, workers' compensation, employee healthcare, comprehensive general and auto liability. Third-party insurance coverage is obtained for property and casualty exposures above predetermined deductibles as well as those risks required to be insured by law or contract. Provisions for losses expected under the insurance programs are recorded based on independent actuarial estimates of the aggregate liabilities for claims incurred.

Employee Benefit Plans — As of January 1, 1998, the Company adopted the provisions of SFAS No. 132, "Employers' Disclosures about Pensions and Other Postretirement Benefits," which is an amendment of SFAS No. 87, No. 88 and No. 106. SFAS No. 132 revises employers' disclosures related to pension and other postretirement plans by requiring, among other things, standardization of disclosures among such plans as well as

additional information on the changes in benefit obligations and fair values of plan assets. It also eliminates certain other disclosures no longer deemed useful. SFAS No. 132 is effective for financial periods beginning after December 15, 1997, and will have no effect on the Company's financial position or results of operations as it does not change the measurement or recognition criteria for such plans.

The Company has adopted the disclosure-only requirements of SFAS No. 123, "Accounting for Stock-Based Compensation," and therefore continues to apply the provisions of Accounting Principles Board ("APB") Opinion No. 25, "Accounting for Stock Issued to Employees," in accounting for its stock-based compensation plans. Pursuant to the requirements of SFAS No. 123, which defines a fair-value-based method of accounting for employee stock options, the Company provides pro forma net earnings and earnings-per-share disclosures as if it were using that statement to account for its employee stock option plans.

Environmental — Environmental expenditures related to existing conditions resulting from past or current operations and from which no current or future benefit is discernible are expensed by the Company. Expenditures that extend the life of the related property or prevent future environmental contamination are capitalized. The Company determines its liability on a site-by-site basis and records a liability when it is probable and can be reasonably estimated. The estimated liability of the Company is not discounted.

A portion of the environmental expenditures incurred for gasoline sites is eligible for refund under state reimbursement programs. A related receivable is recorded for estimated probable refunds. The receivable is discounted if the amount relates to remediation activities which have already been conducted. A receivable is also recorded to reflect estimated probable reimbursement from other parties.

Comprehensive Earnings — In January 1998, the Company adopted the provisions of SFAS No. 130, "Reporting Comprehensive Income," which is required for fiscal years beginning after December 15, 1997. The statement establishes standards for reporting comprehensive earnings and its components in a full set of general-purpose financial statements. Comprehensive earnings are the changes in equity of a business enterprise during a period from net earnings and other events, except activity resulting from investments by owners and distributions to owners.

2. ACQUISITIONS

On May 4, 1998, the Company purchased 100% of the common stock of Christy's Market, Inc., a Massachusetts company that operates 135 convenience stores in the New England area. On May 12, 1998, the Company purchased the assets of 20 'red D mart' convenience stores in the South Bend, Indiana, area from MDK Corporation of Goshen, Indiana.

These acquisitions were accounted for under the purchase method of accounting and, accordingly, the results of operations of the acquired businesses have been included in the accompanying consolidated financial statements from their dates of acquisition. Pro forma information is not provided as the impact of the acquisitions does not have a material effect on the Company's results of operations, cash flows or financial position.

The following information is provided as supplemental cash flow disclosure for the acquisitions of businesses as reported in the Consolidated Statements of Cash Flows for the year ended December 31, 1998 (dollars in thousands):

Fair value of assets acquired	$ 75,479
Fair value of liabilities assumed	42,478
Cash paid	33,001
Less cash acquired	72
Net cash paid for acquisitions	$ 32,929

3. ACCOUNTS RECEIVABLE

(Dollars in Thousands)

December 31	1998	1997
Trade accounts receivable	**$ 59,985**	$ 50,235
Franchisee accounts receivable	**74,176**	55,449
Environmental cost reimbursements (net of long-term portion of $42,012 and $38,716) — see Note 14	**9,798**	12,219
Other accounts receivable	**12,854**	15,388
	156,813	133,291
Allowance for doubtful accounts	**(8,767)**	(6,796)
	$ 148,046	$ 126,495

4. INVENTORIES

(Dollars in Thousands)

December 31	1998	1997
Merchandise	**$ 74,835**	$ 78,022
Gasoline	**26,210**	26,518
	$ 101,045	$ 104,540

Inventories stated on the LIFO basis that are included in inventories in the accompanying Consolidated Balance Sheets were $50,242 and $59,914 for merchandise and $21,070 and $21,446 for gasoline at December 31, 1998 and 1997, respectively. These amounts are less than replacement cost by $33,804 and $26,980 for merchandise and $600 and $4,545 for gasoline at December 31, 1998 and 1997, respectively.

5. OTHER CURRENT ASSETS

(Dollars in Thousands)

December 31	1998	1997
Prepaid expenses	$ 26,670	$ 22,640
Deferred tax assets — see Note 15	61,260	65,640
Restricted cash — see Note 10	22,810	—
Advances for lottery and other tickets	22,247	20,856
Reimbursable equipment purchases under the master lease facility — see Note 13	22,892	2,254
Other	6,752	5,611
	$ 162,631	$ 117,001

6. PROPERTY AND EQUIPMENT

(Dollars in Thousands)

December 31	1998	1997
Cost:		
Land	$ 493,369	$ 461,568
Buildings and leaseholds	1,437,542	1,356,856
Equipment	1,084,694	911,598
Construction in process	102,524	38,152
	3,118,129	2,768,174
Accumulated depreciation and amortization	(1,465,197)	(1,351,487)
	$ 1,652,932	$ 1,416,687

7. OTHER ASSETS

(Dollars in Thousands)

December 31	1998	1997
SEJ license royalty intangible (net of accumulated amortization of $181,034 and $165,019)	$ 137,466	$ 153,482
Other license royalty intangibles (net of accumulated amortization of $32,259 and $29,423)	24,345	27,181
Environmental cost reimbursements — see Note 14	42,012	38,716
Goodwill (net of accumulated amortization of $449)	30,671	—
Investments in domestic securities	27,011	15,101
Other (net of accumulated amortization of $7,060 and $5,827)	62,805	52,273
	$ 324,310	$ 286,753

8. ACCRUED EXPENSES AND OTHER LIABILITIES

(Dollars in Thousands)

December 31	1998	1997
Insurance	$ 54,059	$ 69,412
Compensation	47,216	42,931
Taxes	51,807	52,400
Lotto, lottery and other tickets	37,446	36,922
Other accounts payable	36,492	30,989
Environmental costs — see Note 14	22,364	19,818
Profit sharing — see Note 12	16,490	14,780
Interest	20,432	17,173
Other current liabilities	76,092	69,419
	$ 362,398	$ 353,844

The Company continues to review the functions necessary to enable its stores to respond faster, more creatively and more cost efficiently to rapidly changing customer needs and preferences. To accomplish this goal, the Company continues to realign and reduce personnel.

For the year ended December 31, 1998, the Company accrued $7,643 for severance benefits for the reduction in force of approximately 120 management and administrative employees. The cost of the severance benefits was recorded in OSG&A and, as of December 31, 1998, $2,730 of severance benefits has been paid against the accrual. There was no material change in estimate of the accrual during 1998.

9. DEBT

(Dollars in Thousands)

December 31	1998	1997
Bank Debt Term Loans	$ 168,750	$ 225,000
Bank Debt revolving credit facility	295,000	62,000
Commercial paper	350,000	350,000
5% First Priority Senior Subordinated Debentures due 2003	317,866	350,556
4½% Second Priority Senior Subordinated Debentures (Series A) due 2004	144,472	159,823
4% Second Priority Senior Subordinated Debentures (Series B) due 2004	22,590	23,645
12% Second Priority Senior Subordinated Debentures (Series C) due 2009	—	51,853
Yen Loans	223,751	168,198
7½% Cityplace Term Loan due 2005	272,883	277,926
Capital lease obligations	137,152	125,777
Other	8,133	8,606
	1,940,597	1,803,384
Less long-term debt due within one year	151,754	208,839
	$ 1,788,843	$ 1,594,545

Bank Debt — In February 1997, the Company became obligated to a group of lenders under a new, unsecured credit agreement ("Credit Agreement") that includes a $225 million term loan and a $400 million revolving credit facility. A sublimit of $150 million for letters of credit is included in the revolving credit facility. In addition, to the extent outstanding letters of credit are less than the $150 million maximum, the excess availability can be used for additional borrowings under the revolving credit facility.

Payments on the term loan, which matures on December 31, 2001, commenced March 31, 1998, when the first installment of 16 quarterly installments of $14,063 was paid. Upon expiration of the revolving credit facility in February 2002, all the then-outstanding letters of credit must expire and may need to be replaced, and all other amounts then outstanding will be due and payable in full. At December 31, 1998, outstanding letters of credit under the facility totaled $71,124.

Interest on the term loan and borrowings under the revolving credit facility is generally payable quarterly and is based on a variable rate equal to the administrative agent bank's base rate or, at the Company's option, at a rate equal to a reserve-adjusted Eurodollar rate plus .225% per year. A fee of .325% per year on the outstanding amount of letters of credit is required to be paid quarterly. In addition, a facility fee of .15% per year is charged on the aggregate amount of the credit agreement facility and is payable quarterly. The weighted-average interest rate on the term loan outstanding at December 31, 1998 and 1997, respectively, was 5.6% and 6.1%. The weighted-average interest rate on the revolving credit facility borrowings outstanding at December 31, 1998 and 1997, respectively, was 5.6% and 8.5%.

The Credit Agreement contains various financial and operating covenants which require, among other things, the maintenance of certain financial ratios including interest and rent coverage, fixed-charge coverage and senior indebtedness to earnings before interest, income taxes, depreciation and amortization. The Credit Agreement also contains various covenants which, among other things, (a) limit the Company's ability to incur or guarantee indebtedness or other liabilities other than under the Credit Agreement, (b) restrict the Company's ability to engage in asset sales and sale/leaseback transactions, (c) restrict the types of investments the Company can make and (d) restrict the Company's ability to pay cash dividends, redeem or prepay principal and interest on any subordinated debt and certain senior debt.

In March 1999, the Credit Agreement was amended prospectively to change the existing financial covenant levels to allow the Company more flexibility and to increase the levels of capital expenditures allowable to continue its store-growth strategy. Also, in connection with this amendment, the interest rate on borrowings was changed to a reserve-adjusted Eurodollar rate plus .475% instead of the previous increment of .225%.

Commercial Paper — As of December 31, 1998, the Company had a facility that provided for the issuance of up to $400 million in commercial paper. Effective January 15, 1999, the availability of borrowings under this facility was increased to $650 million. At both December 31, 1998 and 1997, $350 million of the respective $368,348 and $398,744 outstanding principal amounts, net of discount, was classified as long-term debt since the Company intends to maintain at least this amount outstanding during the next year. Such debt is unsecured and is fully and unconditionally guaranteed by IY. IY has agreed to continue its guarantee of all commercial paper issued through 2000. While it is not anticipated that IY would be required to perform under its commercial paper guarantee, in the event IY makes any payments under the guarantee, the Company and IY have entered into an agreement by which the Company is required to reimburse IY subject to restrictions in the Credit Agreement. The weighted-average interest rate on commercial paper borrowings outstanding at December 31, 1998 and 1997, respectively, was 5.2% and 5.8%.

Debentures — The Debentures are accounted for in accordance with SFAS No. 15, "Accounting by Debtors and Creditors for Troubled Debt Restructuring," and were recorded at an amount equal to the future undiscounted cash payments, both principal and interest ("SFAS No. 15 Interest"). Accordingly, no interest expense will be recognized over the life of these securities, and cash interest payments will be charged against the recorded amount of such securities. Interest on all of the Debentures is payable in cash semiannually on June 15 and December 15 of each year.

The 5% First Priority Senior Subordinated Debentures, due December 15, 2003 ("5% Debentures"), had an outstanding principal balance of $254,293 at December 31, 1998, and are redeemable at any time at the Company's option at 100% of the principal amount.

The Second Priority Senior Subordinated Debentures were issued in three series, and each series is redeemable at any time at the Company's option at 100% of the principal amount and are described as follows:

- 4½% Series A Debentures, due June 15, 2004 ("4½% Debentures"), had an outstanding principal balance of $115,809 at December 31, 1998.
- 4% Series B Debentures, due June 15, 2004 ("4% Debentures"), had an outstanding principal balance of $18,516 at December 31, 1998.
- 12% Series C Debentures, due June 15, 2009 ("12% Debentures"), were redeemed by the Company on March 31, 1998, with a portion of the proceeds from the issuance of $80 million principal amount of Convertible Quarterly Income Debt Securities due 2013 ("1998 QUIDS") to IY and SEJ (see Note 10). The 12% Debentures had an outstanding principal balance of $21,787 when they were redeemed.

The Company also utilized a portion of the proceeds from the 1998 QUIDS to purchase $15,700 principal amount of its 5% Debentures, $7,845 principal amount of its 4½% Debentures and $250 principal amount of its 4% Debentures during the fourth quarter of 1998. The partial purchases of these debentures, together with the redemption of the 12% Debentures, resulted in an extraordinary gain of $23,324 (net of current tax effect of $14,912) as a result of the discounted purchase price and the inclusion of SFAS No. 15 Interest in the carrying amount of the debt.

In addition, the Company purchased $15,000 principal amount of its 5% Debentures in January 1999 and $4,418 principal amount of its 4½% Debentures in February 1999 with a portion of the proceeds of the 1998 QUIDS. These partial purchases resulted in an extraordinary gain of $4,290 (net of current tax effect of $2,743) in 1999 as a result of the discounted purchase price and the inclusion of SFAS No. 15 Interest in the carrying amount of the debt.

Prior to the partial purchases, the 5% Debentures were subject to a sinking fund payment of $8,696 due on December 15, 2002. The Company used its purchase of the 5% Debentures to satisfy all sinking fund requirements so that no sinking fund payments remain.

The Debentures contain certain covenants that, among other things, (a) limit the payment of dividends and certain other restricted payments by both the Company and its subsidiaries, (b) require the purchase by the Company of the Debentures at the option of the holder upon a change of control, (c) limit additional indebtedness, (d) limit future exchange offers, (e) limit the repayment of subordinated indebtedness, (f) require board approval of certain asset sales, (g) limit transactions with certain stockholders and affiliates and (h) limit consolidations, mergers and the conveyance of all or substantially all of the Company's assets.

The First and Second Priority Senior Subordinated Debentures are subordinate to the borrowings outstanding under the Credit Agreement and to previously outstanding mortgages and notes that are either backed by specific collateral or are general unsecured, unsubordinated obligations. The Second Priority Debentures are subordinate to the First Priority Debentures.

Yen Loans — In March 1988, the Company monetized its future royalty payments from SEJ, its area licensee in Japan, through a loan that is nonrecourse to the Company as to principal and interest ("1988 Yen Loan"). The original amount of the yen-denominated debt was 41 billion yen (approximately $327 million at the exchange rate in March 1988) and is collateralized by the Japanese trademarks and a pledge of the future royalty payments. By designating its future royalty receipts during the term of the loan to service the monthly interest and principal payments, the Company has hedged the impact of future exchange rate fluctuations. Payment of the debt is required no later than March 2006 through future royalties from SEJ. The Company believes it is a remote possibility that there will be any principal balance remaining at that date because current royalty projections suggest the 1988 Yen Loan could be repaid as early as 2001. Upon the later of February 28, 2000, or the date which is one year following the final repayment of the 1988 Yen Loan, royalty payments from SEJ will be reduced by approximately two-thirds in accordance with the terms of the license agreement. The interest rate was 6.25% as of December 31, 1997, and was reset to 3.10% on March 10, 1998. The new rate was .5% in excess of the Japanese long-term lending rate on that date.

On April 30, 1998, funding occurred on an additional yen-denominated loan ("1998 Yen Loan") for 12.5 billion yen or $96.5 million of proceeds. The 1998 Yen Loan has an interest rate of 2.325% and will be repaid from the Seven-Eleven Japan area license royalty income beginning in 2001, after the 1988 Yen Loan has been retired. Both principal and interest of the loan are nonrecourse to the Company. The Company utilized a short-term put option to lock-in the exchange rate and avoid the risk of foreign currency exchange loss. The put option was financed by selling a call option with the same yen amount and maturity as the put option. Due to market conditions, the call option was not exercised and, as a result, income of $1.6 million was recognized during 1998. Proceeds of the loan were designated for general corporate purposes.

Cityplace Debt — Cityplace Center East Corporation ("CCEC"), a subsidiary of the Company, constructed the headquarters tower, parking garages and related facilities of the Cityplace Center development and is currently obligated to The Sanwa Bank, Limited, Dallas Agency ("Sanwa"), which has a lien on the property financed. The debt with Sanwa has monthly payments of principal and interest based on a 25-year amortization at 7.5%, with the remaining principal due on March 1, 2005 (the "Cityplace Term Loan").

The Company is occupying part of the building as its corporate headquarters and the balance is subleased. As additional consideration through the extended term of the debt, CCEC will pay to Sanwa an amount that it receives from the Company which is equal to the net sublease income that the Company receives on the property and 60% of the proceeds, less $275 million and permitted costs, upon a sale or refinancing of the building.

Maturities — Long-term debt maturities assume the continuance of the commercial paper program. The maturities, which include capital lease obligations as well as SFAS No. 15 Interest accounted for in the recorded amount of the Debentures, are as follows (dollars in thousands):

1999	$ 151,754
2000	150,881
2001	132,794
2002	78,700
2003	306,872
Thereafter	1,119,596
	$ 1,940,597

10. CONVERTIBLE QUARTERLY INCOME DEBT SECURITIES

In November 1995, the Company issued $300 million principal amount of Convertible Quarterly Income Debt Securities due 2010 ("1995 QUIDS") to IY and SEJ. The 1995 QUIDS have an interest rate of 4.5% and give the Company the right to defer interest payments thereon for up to 20 consecutive quarters. The holder of the 1995 QUIDS can convert the debt into a maximum of 72,111,917 shares of the Company's common stock. The conversion rate represents a premium to the market value of the Company's common stock at the time of issuance of the 1995 QUIDS. As of December 31, 1998, no shares had been issued as a result of debt conversion.

In February 1998, the Company issued $80 million principal amount of 1998 QUIDS, which have a 15-year life, no amortization and an interest rate of 4.5%. The instrument gives the Company the right to defer interest payments thereon for up to 20 consecutive quarters. The debt mandatorily converts into 32,508,432 shares of the Company's common stock if the Company's stock achieves certain levels after the third anniversary of issuance. A portion of the proceeds from the 1998 QUIDS was used to redeem the Company's 12% Debentures at par and to fund the partial purchases of its other Debentures (see Note 9). At December 31, 1998, the Company had $22,810 designated as restricted cash to be used for future purchases of Debentures. The 1998 QUIDS, together with the 1995 QUIDS (collectively, "Convertible Debt"), are subordinate to all existing debt.

In addition to the principal amount of the Convertible Debt, the financial statements include interest payable of $723 in 1998 and $563 in 1997 as well as interest expense of $16,801, $13,733 and $13,658 in 1998, 1997 and 1996, respectively, related to the Convertible Debt.

11. FINANCIAL INSTRUMENTS

Fair Value — The disclosure of the estimated fair value of financial instruments has been determined by the Company using available market information and appropriate valuation methodologies as indicated below.

The carrying amounts of cash and cash equivalents, trade accounts receivable, trade accounts payable and accrued expenses and other liabilities are reasonable estimates of their fair values. Letters of credit are included in the estimated fair value of accrued expenses and other liabilities.

The carrying amounts and estimated fair values of other financial instruments at December 31, 1998, are listed in the following table:

(Dollars in Thousands)	Carrying Amount	Estimated Fair Value
Bank Debt	$ 463,750	$ 463,750
Commercial Paper	368,348	368,348
Debentures	484,928	334,609
Yen Loans	223,751	250,922
Cityplace Term Loan	272,883	301,404
Convertible Debt — not practicable to estimate fair value	380,000	—

The methods and assumptions used in estimating the fair value for each of the classes of financial instruments presented in the table above are as follows:

— The carrying amount of the Bank Debt approximates fair value because the interest rates are variable.

— Commercial paper borrowings are sold at market interest rates and have an average remaining maturity of less than 47 days. Therefore, the carrying amount of commercial paper is a reasonable estimate of its fair value. The guarantee of the commercial paper by IY is an integral part of the estimated fair value of the commercial paper borrowings.

— The fair value of the Debentures is estimated based on December 31, 1998, bid prices obtained from investment banking firms where traders regularly make a market for these financial instruments. The carrying amount of the Debentures includes $96,309 of SFAS No. 15 Interest.

— The fair value of the Yen Loans is estimated by calculating the present value of the future yen cash flows at current interest and exchange rates.

— The fair value of the Cityplace Term Loan is estimated by calculating the present value of the future cash flows at current interest rates.

— It is not practicable, without incurring excessive costs, to estimate the fair value of the Convertible Debt (see Note 10) at December 31, 1998. The fair value would be the sum of the fair values assigned to both an interest rate and an equity component of the debt by a valuation firm.

Derivatives — The Company uses derivative financial instruments to reduce its exposure to market risk resulting from fluctuations in both foreign exchange rates (see Note 9) and interest rates. On June 26, 1998, the Company entered into an interest rate swap agreement that fixed the interest rate at 5.395% on $250 million notional principal amount of floating rate debt until June 26, 2003. The interest rate swap had a fair value of $(10,821) as of December 31, 1998, which reflects the estimated amount that the Company would have to pay to terminate the swap. This agreement was amended on February 9, 1999, and the Company will pay a fixed interest rate of 6.096% on the floating rate debt until February 9, 2004. A major financial institution, as counterparty to the agreement, will pay the Company a floating interest rate based on three-month LIBOR during the term of the agreement in exchange for the Company paying the fixed interest rate. Interest payments related to the original agreement commenced September 28, 1998, and interest payments related to the amended agreement will commence on May 9, 1999. Interest payments are made quarterly by both parties. Except for the option component discussed below, the swap is accounted for as a hedge and, accordingly, any difference between amounts paid and received under the swap are recorded as interest expense. The impact on net interest expense as a result of this agreement was nominally favorable for the year ended December 31, 1998, and the Company does not anticipate a material impact on its earnings as a result of the amended agreement. The Company is at risk of loss from this swap agreement in the event of nonperformance by the counterparty.

Upon expiration of the initial swap term, the original agreement was extendible for an additional five years at the option of the counterparty. This extendible option component of the original agreement was unwound by the amended agreement. The option component was recognized at fair value and marked to market as of December 31, 1998, and also at the time of unwinding. Due to declining interest rates throughout the third and fourth quarters, the Company recognized $3,677 of expense related to the option component. However, with respect to its unhedged floating rate debt, the Company experienced a positive economic benefit from the declining interest rates during the same period. In the first quarter of 1999, the Company recognized income of $1,505 as a result of the mark-to-market adjustment of the option component through the date of the unwinding.

The Company is currently reviewing SFAS No. 133, "Accounting for Derivative Instruments and Hedging Activities." The statement establishes accounting and reporting standards for derivative instruments, including certain derivative instruments embedded in other contracts, and for hedging activities. SFAS No. 133 becomes effective for all fiscal quarters of fiscal years beginning after June 15, 1999, and earlier application is permitted as of the beginning of any fiscal quarter subsequent to June 15, 1998. The Company intends to adopt the provisions of this statement as of January 1, 2000. The impact of the adoption of SFAS No. 133 has not been determined at this time due to the Company's continuing investigation of its financial instruments and the applicability of SFAS No. 133 to them.

12. EMPLOYEE BENEFIT PLANS

Profit Sharing Plans — The Company maintains profit sharing plans for its U.S. and Canadian employees. In 1949, the Company excluding its Canadian subsidiary ("Southland") adopted The Southland Corporation Employees' Savings and Profit Sharing Plan (the "Savings and Profit Sharing Plan") and, in 1970, the Company's Canadian subsidiary adopted the Southland Canada, Inc., Profit Sharing Pension Plan. In 1997, the name of the Canadian plan was changed to the Southland Canada, Inc., Pension Plan. These plans provide retirement benefits to eligible employees.

Contributions to the Savings and Profit Sharing Plan, a 401(k) defined contribution plan, are made by both the participants and Southland. Southland contributes the greater of approximately 10% of its net earnings minus the amount contributed to The Southland Corporation Supplemental Executive Retirement Plan for Eligible Employees (the "Supplemental Executive Retirement Plan") or an amount determined by Southland. Net earnings are calculated without regard to the contribution to the Savings and Profit Sharing Plan, federal income taxes, gains from debt repurchases and refinancings and, at the discretion of Southland's president, income from accounting changes. The contribution by Southland is generally allocated to the participants on the basis of their individual contribution and years of participation in the Savings and Profit Sharing Plan. The provisions of the Southland Canada, Inc., Pension Plan are similar to those of the Savings and Profit Sharing Plan. Total contributions to these plans for the years ended December 31, 1998, 1997 and 1996 were $13,403, $12,977 and $14,069, respectively, and are included in OSG&A.

Supplemental Executive Retirement Plan — Effective January 1, 1998, the Company established the Supplemental Executive Retirement Plan, which is an unfunded employee benefit plan maintained primarily to allow compensation to be deferred by highly compensated employees as defined by the Internal Revenue Service. Benefits under this plan constitute general obligations of the Company, subject to the claims of general creditors of the Company, and participants have no security or other interest in such funds.

Contributions to the Supplemental Executive Retirement Plan, a deferred compensation plan, are made by the participant and may be made by the Company. A participant may elect to defer a maximum

of 12 percent of eligible compensation. The Company may make a matching contribution, if so authorized each plan year, up to a maximum of six percent of the participant's eligible compensation minus the amount of the participant's deferral to the Savings and Profit Sharing Plan. Matching contributions, if any, will be credited to the participant's account at the same rate that Southland matches under the Savings and Profit Sharing Plan, but using years of service with the Company, minus one, rather than years of participation in the Savings and Profit Sharing Plan to determine a participant's group. There were no Company contributions to this plan for the year ended December 31, 1998.

Postretirement Benefits — The Company's group insurance plan (the "Insurance Plan") provides postretirement medical and dental benefits for all retirees that meet certain criteria. Such criteria include continuous participation in the Insurance Plan ranging from 10 to 15 years depending on hire date, and the sum of age plus years of continuous service equal to at least 70. The Company contributes toward the cost of the Insurance Plan a fixed dollar amount per retiree based on age and number of dependents covered, as adjusted for actual claims experience. All other future costs and cost increases will be paid by the retirees. The Company continues to fund its cost on a cash basis; therefore, no plan assets have been accumulated.

The following information on the Company's Insurance Plan is provided:

(Dollars in Thousands)

December 31	1998	1997
Change in Benefit Obligation:		
Net benefit obligation at beginning of year	**$ 21,238**	$ 21,197
Service cost	**536**	521
Interest cost	**1,523**	1,535
Plan participants' contributions	**2,953**	2,413
Actuarial (gain) loss	**894**	(704)
Gross benefits paid	**(4,230)**	(3,724)
Net benefit obligation at end of year	**$ 22,914**	$ 21,238
Change in Plan Assets:		
Fair value of plan assets at beginning of year	**$ 0**	$ 0
Employer contributions	**1,277**	1,311
Plan participants' contributions	**2,953**	2,413
Gross benefits paid	**(4,230)**	(3,724)
Fair value of plan assets at end of year	**$ 0**	$ 0
Funded status at end of year	**$ (22,914)**	$ (21,238)
Unrecognized net actuarial (gain) loss	**(6,270)**	(7,724)
Accrued benefit costs	**$ (29,184)**	$ (28,962)

(Dollars in Thousands)

Years Ended December 31	1998	1997	1996
Components of Net Periodic Benefit Cost:			
Service cost	**$ 536**	$ 521	$ 595
Interest cost	**1,523**	1,535	1,496
Amortization of actuarial (gain) loss	**(560)**	(603)	(498)
Net periodic benefit cost	**$ 1,499**	$ 1,453	$ 1,593
Weighted-Average Assumptions Used:			
Discount rate	**6.75%**	7.25%	7.50%
Rate of compensation increase	**5.00%**	5.00%	5.00%
Health care cost trend on covered charges:			
1996 trend	**N/A**	N/A	11.00%
1997 trend	**N/A**	10.00%	10.00%
1998 trend	**9.00%**	9.00%	9.00%
Ultimate trend	**6.00%**	6.00%	6.00%
Ultimate trend reached in	**2001**	2001	2001

There was no effect of a one-percentage-point increase or decrease in assumed health care cost trend rates on either the total service and interest cost components or the postretirement benefit obligation for the years ended December 31, 1998, 1997 and 1996 as the Company contributes a fixed dollar amount.

Stock Incentive Plan — The Southland Corporation 1995 Stock Incentive Plan (the "Stock Incentive Plan") was adopted by the Company in October 1995 and approved by the shareholders in April 1996. The Stock Incentive Plan provides for the granting of stock options, stock appreciation rights, performance shares, restricted stock, restricted stock units, bonus stock and other forms of stock-based awards and authorizes the issuance of up to 41 million shares over a ten-year period to certain key employees and officers of the Company. All options granted in 1998, 1997 and 1996 were granted at an exercise price that was equal to the fair market value on the date of grant. The options granted are exercisable in five equal installments beginning one year after grant date with possible acceleration thereafter based upon certain improvements in the price of the Company's common stock.

The fair value of each option grant is estimated on the date of grant using the Black-Scholes option-pricing model with the following weighted-average assumptions used for the options granted: for each year presented, expected life of five years and no dividend yields, combined with risk-free interest rates of 4.50%, 5.81% and 6.39% in 1998, 1997 and 1996, respectively, and expected volatility of 61.76% in 1998, 51.37% in 1997 and 55.49% in 1996.

A summary of the status of the Stock Incentive Plan as of December 31, 1998, 1997 and 1996, and changes during the years ending on those dates, is presented below:

	1998		1997		1996	
Fixed Options	**Shares (000's)**	**Weighted-Average Exercise Price**	Shares (000's)	Weighted-Average Exercise Price	Shares (000's)	Weighted-Average Exercise Price
Outstanding at beginning of year	**10,500**	**$ 2.8903**	7,618	$ 3.0895	3,864	$ 3.1875
Granted	**3,359**	**1.9063**	3,390	2.4690	3,978	3.0000
Exercised	**—**	**—**	—	—	—	—
Forfeited	**(431)**	**2.8693**	(508)	3.0679	(224)	3.1875
Outstanding at end of year	**13,428**	**$ 2.6448**	10,500	$ 2.8903	7,618	$ 3.0895
Options exercisable at year-end	**4,044**	**$ 3.0074**	2,126	$ 3.1231	728	$ 3.1875
Weighted-average fair value of options granted during the year	**$ 1.0741**		$ 1.2691		$ 1.6413	

	Options Outstanding				Options Exercisable	
Range of Exercise Prices	**Options Outstanding at 12/31/98**	**Weighted-Average Remaining Contractual Life**	**Weighted-Average Exercise Price**		**Options Exercisable at 12/31/98**	**Weighted-Average Exercise Price**
$ 1.9063	3,359,300	9.79	$ 1.9063		—	—
2.4690	3,234,500	8.87	2.4690		646,900	$ 2.4690
3.0000	3,515,940	7.75	3.0000		1,406,376	3.0000
3.1875	3,318,100	6.81	3.1875		1,990,860	3.1875
1.9063-3.1875	13,427,840	8.30	2.6448		4,044,136	3.0074

The Company is accounting for the Stock Incentive Plan under the provisions of APB No. 25 and, accordingly, no compensation cost has been recognized. If compensation cost had been determined based on the fair value at the grant date for awards under this plan consistent with the method prescribed by SFAS No. 123, the Company's net earnings and earnings per share for the years ended December 31, 1998, 1997 and 1996, would have been reduced to the pro forma amounts indicated in the table below:

(Dollars in Thousands, Except Per-Share Data)	**1998**	1997	1996
Net earnings:			
As reported	**$ 74,048**	$ 70,042	$ 89,476
Pro forma	**72,017**	68,542	88,520
Earnings per common share:			
As reported:			
Basic	**$ .18**	$ .17	$ .22
Diluted	**.17**	.16	.20
Pro forma:			
Basic	**$ .18**	$ .17	$ .22
Diluted	**.16**	.16	.20

13. LEASES

Leases — Certain property and equipment used in the Company's business is leased. Generally, real estate leases are for primary terms from 14 to 20 years with options to renew for additional periods, and equipment leases are for terms from one to ten years. The leases do not contain restrictions that have a material effect on the Company's operations.

In April 1997, the Company obtained commitments from the same group of lenders that participated in the Credit Agreement (see Note 9) for up to $115 million of lease financing under a master lease facility to be used primarily for electronic point-of-sale equipment associated with the Company's retail information system. As of December 31, 1998, the Company had received $44,748 of the available funding under the lease facility and intends to use the remainder of the funding as the system rollout continues. Lease payments are variable based on changes in LIBOR.

Individual leases under this master lease facility have initial terms that expire on June 30, 2000, at which time the Company has an option to cancel all leases under this facility by purchasing the equipment or arranging its sale to a third party. The Company also has the option to renew the leases semiannually until five years after the beginning of the individual leases. At each semiannual renewal date, the Company has the option to purchase the equipment and end the lease. Individual leases may be extended beyond five years through an extended rental agreement.

The composition of capital leases reflected as property and equipment in the Consolidated Balance Sheets is as follows:

(Dollars in Thousands) **December 31**	1998	1997
Buildings	$ 129,520	$ 111,946
Equipment	47,568	43,115
	177,088	155,061
Accumulated amortization	(69,989)	(72,059)
	$ 107,099	$ 83,002

The present value of future minimum lease payments for capital lease obligations is reflected in the Consolidated Balance Sheets as long-term debt. The amount representing imputed interest necessary to reduce net minimum lease payments to present value has been calculated generally at the Company's incremental borrowing rate at the inception of each lease.

Future minimum lease payments for years ending December 31 are as follows:

(Dollars in Thousands)	Capital Leases	Operating Leases
1999	$ 34,116	$ 122,657
2000	31,653	105,298
2001	28,481	91,640
2002	22,805	75,597
2003	14,846	56,588
Thereafter	85,633	221,003
Future minimum lease payments	217,534	$ 672,783
Estimated executory costs	(55)	
Amount representing imputed interest	(80,327)	
Present value of future minimum lease payments	$ 137,152	

Minimum noncancelable sublease rental income to be received in the future, which is not included above as an offset to future payments, totals $14,436 for capital leases and $14,571 for operating leases.

Rent expense on operating leases for the years ended December 31, 1998, 1997 and 1996, totaled $143,539, $136,516 and $132,760, respectively, including contingent rent expense of $10,441, $9,360 and $9,438, but reduced by sublease rent income of $5,909, $6,620 and $7,175. Contingent rent expense on capital leases for the years ended December 31, 1998, 1997 and 1996, was $1,818, $1,987 and $2,088, respectively. Contingent rent expense is generally based on sales levels or changes in the Consumer Price Index.

Leases with the Savings and Profit Sharing Plan — At December 31, 1998, the Savings and Profit Sharing Plan owned 12 stores leased to the Company under capital leases and 612 stores leased to the Company under operating leases at rentals which, in the opinion of management, approximated market rates at the date of lease. In addition, in 1998, 1997 and 1996, there were 99, 64 and 38 leases, respectively, that either expired or, as a result of properties that were sold by the Savings and Profit Sharing Plan to third parties, were canceled or assigned to the new owner. Also, five properties and one property, respectively, were sold to the Company by the Savings and Profit Sharing Plan in 1998 and 1997.

Included in the consolidated financial statements are

the following amounts related to leases with the Savings and Profit Sharing Plan:

(Dollars in Thousands) December 31	1998	1997
Buildings (net of accumulated amortization of $886 and $4,830)	$ 281	$ 513
Capital lease obligations (net of current portion of $56 and $709)	$ 314	$ 321

(Dollars in Thousands) Years Ended December 31	1998	1997	1996
Rent expense under operating leases and amortization of capital lease assets	$ 19,987	$ 23,961	$ 25,670
Imputed interest expense on capital lease obligations	$ 59	$ 159	$ 299
Capital lease principal payments included in principal payments under long-term debt agreements	$ 594	$ 1,183	$ 1,580

14. COMMITMENTS AND CONTINGENCIES

McLane Company, Inc. — In connection with the 1992 sale of distribution and food center assets to McLane, the Company and McLane entered into a ten-year service agreement under which McLane is making its distribution services available to 7-Eleven stores in the United States. If the Company does not fulfill its obligation to McLane during this time period, the Company must reimburse McLane on a pro-rata basis for the transitional payment received at the time of the transaction. The original payment received of $9,450 in 1992 is being amortized to cost of goods sold over the life of the agreement. The Company has exceeded the minimum annual purchases each year and expects to exceed the minimum required purchase levels in future years.

Citgo Petroleum Corporation — In 1986, the Company entered into a 20-year product purchase agreement with Citgo to buy specified quantities of gasoline at market prices. These prices are determined pursuant to a formula based on the prices posted by gasoline wholesalers in the various market areas where the Company purchases gasoline from Citgo. Minimum required annual purchases under this agreement are generally the lesser of 750 million gallons or 35% of gasoline purchased by the Company for retail sale. The Company has exceeded the minimum required annual purchases each year and expects to exceed the minimum required annual purchase levels in future years.

Environmental — In December 1988, the Company closed its chemical manufacturing facility in New Jersey. As a result, the Company is required to conduct environmental remediation at the facility and has submitted a clean-up plan to the New Jersey Department of Environmental Protection (the "State"), which provides for active remediation of the site for approximately a three-to-five-year period as well as continued groundwater monitoring and treatment for a projected 15-year period. The Company has received conditional approval of its clean-up plan. The projected 15-year clean-up period represents a reduction from the previously reported 20-year period and is a result of revised estimates as determined by an independent environmental management company in the first quarter of 1997. These revised estimates, which generally resulted from the conditional approval of the Company's plan, reduced both the estimated time and the estimated costs to complete the project and resulted in decreasing the liability and the related receivable balances by $16.3 million and $9.7 million, respectively. The Company has recorded undiscounted liabilities representing its best estimates of the clean-up costs of $8,726 and $10,442 at December 31, 1998 and 1997, respectively. Of this amount, $6,462 and $8,624 are included in deferred credits and other liabilities and the remainder in accrued expenses and other liabilities for the respective years.

In 1991, the Company and the former owner of the facility executed a final settlement pursuant to which the former owner agreed to pay a substantial portion of the clean-up costs. Based on the terms of the settlement agreement and the financial resources of the former owner, the Company has recorded receivable amounts of $5,098 and $6,126 at December 31, 1998 and 1997, respectively. Of this amount, $3,750 and $4,907 are included in other assets and the remainder in accounts receivable for 1998 and 1997, respectively.

Additionally, the Company accrues for the anticipated future costs and the related probable state reimbursement amounts for remediation activities at its existing and previously operated gasoline store sites where releases of regulated substances have been detected. At December 31, 1998 and 1997, respectively, the Company's estimated undiscounted liability for these sites was $41,897 and $40,880, of which $21,797 and $22,880 are included in deferred credits and other liabilities and the remainder is included in accrued expenses and other liabilities. These estimates were based on the Company's prior experience with gasoline sites and its consideration of such factors as the age of the tanks, location of tank sites and experience with contractors who perform environmental assessment and remediation work.

The Company anticipates that substantially all of the future remediation costs for detected releases at these sites as of December 31, 1998, will be incurred within the next four or five years.

Under state reimbursement programs, the Company is eligible to receive reimbursement for a portion of future remediation costs, as well as a portion of remediation costs previously paid. Accordingly, the Company has recorded net receivable amounts of $46,712 and $44,809 for the estimated probable state reimbursements, of which $38,262 and $33,809 are included in other assets and the remainder in accounts receivable for 1998 and 1997, respectively. In assessing the probability of state reimbursements, the Company takes into consideration each state's fund balance, revenue sources, existing claim backlog, status of clean-up activity and claim ranking systems. As a result of these assessments, the recorded receivable amounts in other assets are net of allowances of $9,992 and $9,704 for 1998 and 1997, respectively. While there is no assurance of the timing of the receipt of state reimbursement funds, based on the Company's experience, the Company expects to receive the majority of state reimbursement funds, except from California, within one to three years after payment of eligible remediation expenses, assuming that the state administrative procedures for processing such reimbursements have been fully developed. The Company estimates that it may take one to six years to receive reimbursement funds from California. Therefore, the portion of the recorded receivable amounts that relates to remediation activities which have already been conducted has been discounted at 4.6% and 5.7% in 1998 and 1997, respectively, to reflect its present value. The 1998 and 1997 recorded receivable amounts are net of discounts of $4,051 and $6,048, respectively.

The estimated future remediation expenditures and related state reimbursement amounts could change within the near future as governmental requirements and state reimbursement programs continue to be implemented or revised.

15. INCOME TAXES

The components of earnings before income taxes and extraordinary gain are as follows:

(Dollars in Thousands)

Years Ended December 31	1998	1997	1996
Domestic (including royalties of $68,329, $67,259 and $63,536 from area license agreements in foreign countries)	**$ 78,719**	$ 109,982	$ 124,316
Foreign	**3,894**	5,313	6,508
	$ 82,613	$ 115,295	$ 130,824

The provision for income taxes on earnings before extraordinary gain in the accompanying Consolidated Statements of Earnings consists of the following:

(Dollars in Thousands)

Years Ended December 31	1998	1997	1996
Current:			
Federal	**$ 1,146**	$ 1,182	$ 5,054
Foreign	**10,753**	11,559	10,704
State	**800**	700	1,800
Subtotal	**12,699**	13,441	17,558
Deferred:			
Provision	**19,190**	31,812	23,790
Income taxes before extraordinary gain	**$ 31,889**	$ 45,253	$ 41,348

Included in the accompanying Consolidated Statements of Shareholders' Equity (Deficit) at December 31, 1998, 1997 and 1996, respectively, are $10,521, $5,877 and $6,882 of income taxes provided on unrealized gains on marketable securities.

Reconciliations of income taxes before extraordinary gain at the federal statutory rate to the Company's actual income taxes provided are as follows:

(Dollars in Thousands)

Years Ended December 31	1998	1997	1996
Taxes at federal statutory rate	**$ 28,915**	$ 40,353	$ 45,788
State income taxes, net of federal income tax benefit	**520**	455	1,170
Foreign tax rate difference	**263**	2,095	1,077
Settlement of IRS examination	**—**	—	(7,261)
Other	**2,191**	2,350	574
	$ 31,889	$ 45,253	$ 41,348

Significant components of the Company's deferred tax assets and liabilities are as follows:

(Dollars in Thousands)

December 31	1998	1997
Deferred tax assets:		
SFAS No. 15 Interest	**$ 43,983**	$ 65,559
Compensation and benefits	**38,823**	40,729
Accrued liabilities	**25,842**	25,980
Accrued insurance	**25,483**	33,838
Tax credit carryforwards	**11,515**	13,981
Debt issuance costs	**6,518**	6,777
Other	**6,075**	6,312
Subtotal	**158,239**	193,176
Deferred tax liabilities:		
Property and equipment	**(70,943)**	(61,687)
Area license agreements	**(63,106)**	(70,459)
Other	**(15,498)**	(10,791)
Subtotal	**(149,547)**	(142,937)
Net deferred taxes	**$ 8,692**	$ 50,239

At both December 31, 1998 and 1997, the Company's net deferred tax asset is recorded in other current assets (see Note 5) and deferred credits and other liabilities. At December 31, 1998, the Company had approximately $11,500 of alternative minimum tax credit carryforwards, which have no expiration date.

16. EARNINGS PER COMMON SHARE

The Company adopted SFAS No. 128, "Earnings per Share," in December 1997. This statement, which replaces APB Opinion No. 15, "Earnings per Share," establishes simplified accounting standards for computing earnings per share ("EPS") and makes them comparable to international EPS standards.

Basic EPS is computed by dividing net earnings by the weighted-average number of common shares outstanding during each year. Diluted EPS is computed by dividing net earnings, plus interest on Convertible Debt (see Note 10) net of tax benefits, by the sum of the weighted-average number of common shares outstanding, the weighted-average number of common shares associated with the Convertible Debt and the dilutive effects of the stock options outstanding (see Note 12) during each year. All prior-period EPS amounts presented have been restated to conform to the provisions of SFAS No. 128.

A reconciliation of the numerators and the denominators of the basic and diluted per-share computations for net earnings, as required by SFAS No. 128, is presented below:

(Dollars in Thousands, Except Per-Share Data)

Years Ended December 31	1998	1997	1996
Basic EPS Computation:			
Earnings (Numerator):			
Earnings before extraordinary gain available to common shareholders	$ 50,724	$ 70,042	$ 89,476
Earnings on extraordinary gain available to common shareholders	23,324	—	—
Net earnings available to common shareholders	$ 74,048	$ 70,042	$ 89,476
Shares (Denominator):			
Weighted-average number of common shares outstanding	409,923	409,923	409,923
Basic EPS:			
Earnings per common share before extraordinary gain	$ .12	$ .17	$ .22
Earnings per common share on extraordinary gain	.06	—	—
Net earnings per common share	$ .18	$ .17	$ .22
Diluted EPS Computation:			
Earnings (Numerator):			
Earnings before extraordinary gain available to common shareholders	$ 50,724	$ 70,042	$ 89,476
Add interest on convertible quarterly income debt securities, net of tax	10,316	8,343	8,297
Earnings before extraordinary gain available to common shareholders plus assumed conversions	61,040	78,385	97,773
Earnings on extraordinary gain available to common shareholders	23,324	—	—
Net earnings available to common shareholders plus assumed conversions	$ 84,364	$ 78,385	$ 97,773
Shares (Denominator):			
Weighted-average number of common shares outstanding	409,923	409,923	409,923
Add effects of assumed conversions:			
Exercise of stock options	119	170	167
Conversion of convertible quarterly income debt securities	99,589	72,112	72,112
Weighted-average number of common shares outstanding plus shares from assumed conversions	509,631	482,205	482,202
Diluted EPS:			
Earnings per common share before extraordinary gain	$ .12	$ .16	$ .20
Earnings per common share on extraordinary gain	.05	—	—
Net earnings per common share	$ .17	$ .16	$ .20

17. PREFERRED STOCK

The Company has 5 million shares of preferred stock authorized for issuance. Any preferred stock issued will have such rights, powers and preferences as determined by the Company's Board of Directors.

18. QUARTERLY FINANCIAL DATA (UNAUDITED)

Summarized quarterly financial data for 1998 and 1997 is as follows:

(Dollars in Millions, Except Per-Share Data) **Year Ended December 31, 1998:**	First Quarter	Second Quarter	Third Quarter	Fourth Quarter	Year
Merchandise sales	$ 1,204	$ 1,421	$ 1,556	$ 1,393	$ 5,574
Gasoline sales	391	424	444	425	1,684
Net sales	1,595	1,845	2,000	1,818	7,258
Merchandise gross profit	411	502	546	469	1,928
Gasoline gross profit	43	44	59	62	208
Gross profit	454	546	605	531	2,136
Income taxes (benefit)	(7)	16	22	1	32
Earnings (loss) before extraordinary gain	(12)	26	36	1	51
Net earnings	6	26	36	6	74
Earnings (loss) per common share before extraordinary gain:					
Basic	(.03)	.06	.09	.01	.12
Diluted	(.03)	.06	.07	.01	.12

The first and fourth quarters include extraordinary gains of $17,871 and $5,453, respectively, resulting from the redemption of the 12% Debentures and the partial purchases of the 5% Debentures, the 4½% Debentures and the 4% Debentures (see Note 9). The first quarter includes an expense of $11,839 resulting from the cumulative effects of a computer equipment lease termination and an accrual of $7,104 for severance benefits and related costs.

(Dollars in Millions, Except Per-Share Data) **Year Ended December 31, 1997:**	First Quarter	Second Quarter	Third Quarter	Fourth Quarter	Year
Merchandise sales	$ 1,169	$ 1,335	$ 1,409	$ 1,269	$ 5,182
Gasoline sales	435	447	465	442	1,789
Net sales	1,604	1,782	1,874	1,711	6,971
Merchandise gross profit	411	476	506	435	1,828
Gasoline gross profit	39	46	46	53	184
Gross profit	450	522	552	488	2,012
Income taxes	4	17	22	2	45
Net earnings	6	26	33	5	70
Earnings per common share:					
Basic	.01	.06	.08	.01	.17
Diluted	.01	.06	.07	.01	.16

To the Board of Directors and Shareholders of
The Southland Corporation
Dallas, Texas

We have audited the accompanying consolidated balance sheets of The Southland Corporation and Subsidiaries as of December 31, 1998 and 1997, and the related consolidated statements of earnings, shareholders' equity (deficit) and cash flows for each of the three years in the period ended December 31, 1998. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of The Southland Corporation and Subsidiaries as of December 31, 1998 and 1997, and the consolidated results of their operations and their cash flows for each of the three years in the period ended December 31, 1998 in conformity with generally accepted accounting principles.

PricewaterhouseCoopers LLP

PricewaterhouseCoopers LLP
Dallas, Texas
February 4, 1999

Directors

Masatoshi Ito
Chairman of the Board;
Director, Honorary Chairman,
Ito-Yokado Group

Toshifumi Suzuki [1]
Vice Chairman of the Board;
President and Chief Executive Officer,
Ito-Yokado Co., Ltd.;
Chairman and Chief Executive Officer,
Seven-Eleven Japan Co., Ltd.

Clark J. Matthews, II
President and
Chief Executive Officer;
Secretary,
The Southland Corporation

James W. Keyes
Executive Vice President
and Chief Operating Officer,
The Southland Corporation

Yoshitami Arai
Chairman of the Board,
Systems International Incorporated

Masaaki Asakura
Senior Vice President,
The Southland Corporation

Timothy Ashida
President,
A.K.K. Associates, Inc.

Jay W. Chai [2]
Chairman of the Board and
Chief Executive Officer,
ITOCHU International Inc.

Gary J. Fernandes [1] [2]
Managing General Partner,
Convergent Partners, LLC

Masaaki Kamata
Director and
Vice Chairman,
Seven-Eleven Japan Co., Ltd.

Kazuo Otsuka [1]
General Manager,
Corporate Development,
Ito-Yokado Co., Ltd.

Asher O. Pacholder [2]
Chairman of the Board
and Chief Financial Officer,
ICO, Inc.

Nobutake Sato
Director and
Executive Vice President,
Ito-Yokado Co., Ltd.

(1) Compensation and Benefits Committee
(2) Audit Committee

Officers

Masatoshi Ito
Chairman of the Board

Toshifumi Suzuki
Vice Chairman of the Board

Clark J. Matthews, II
President and Chief Executive Officer;
Secretary

James W. Keyes
Executive Vice President
and Chief Operating Officer

Masaaki Asakura
Senior Vice President

Rodney A. Brehm
Senior Vice President

Joseph F. Gomes
Senior Vice President,
Logistics

Gary R. Rose
Senior Vice President,
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Canada Division

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Frank Crivello
Vice President,
Northeast Division

Cynthia Davis
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Central Division

Krista Fuller
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Development

Jeff Hamill
Vice President,
Southwest Division

John W. Harris
Vice President,
Florida Division

Gary Lockhart
Vice President,
Gasoline Supply

David M. Podeschi
Vice President,
Foods Merchandising

Nathan D. Potts *
Vice President,
Non-Foods Merchandising

Sharon Powell
Vice President,
Fresh Foods

Jeffrey A. Schenck
Vice President,
Great Lakes Division

Linda Svehlak
Vice President,
Information Systems

Donald E. Thomas
Vice President and Controller

Rick Updyke
Vice President,
Planning

David A. Urbel **
Vice President,
Finance

Ezra Shashoua
Treasurer

* *Retired February 28, 1999*
** *Retiring April 30, 1999*

Corporate Headquarters

The Southland Corporation
2711 North Haskell Ave.
Dallas, TX 75204-2906
(214) 828-7011

Mailing Address:
P.O. Box 711
Dallas, TX 75221-0711

Web Address:
www.7-Eleven.com

Form 10-K and Other Investor Information

Requests for the Form 10-K for the year ended December 31, 1998, and quarterly financial information should be addressed to the Investor Relations Department at the above address, or telephone (214) 828-7587.

Annual reports are mailed to all shareholders of record. Investors may receive quarterly information regularly by requesting to be included on the company's mailing list.

A recorded company update can be reached and requests for information can be left 24 hours a day by calling (214) 828-7587

Annual Meeting

The annual meeting will be held at 9:30 a.m. CDT on Wednesday, April 28, 1999, in the Cityplace Conference Center at the company's headquarters. All shareholders and bondholders are cordially invited to attend.

Auditors

PricewaterhouseCoopers LLP
Dallas, Texas

Common Stock

Southland's common stock is traded on The Nasdaq Stock Market under the ticker symbol SLCM. There were 2,670 shareholders of record as of March 12, 1999.

The company pays no dividends on its common equity as such payments are restricted by the indentures governing its outstanding securities and by Southland's Credit Agreement with its senior lenders.

The table below sets forth the high, low and closing market prices for the periods indicated as provided by Nasdaq.

Price Range:

Quarters	High	Low	Close
1998			
First	$ 3 1/32	$ 1 9/16	$ 2 5/64
Second	3 1/32	2 1/16	2 3/4
Third	3 1/32	2 1/16	2 1/2
Fourth	2 3/8	1 3/4	1 29/32
1997			
First	$ 3 9/16	$ 2 21/32	$ 3 5/32
Second	3 11/16	3 1/8	3 11/32
Third	3 13/32	2 1/2	2 9/16
Fourth	2 7/8	1 23/32	2 1/8

Common Stock Transfer Agent/Registrar

Harris Trust and Savings Bank
77 Water Street, 4th Floor
New York, NY 10005
(212) 701-7681
(800) 926-1269

Other Securities

The following other Southland securities are traded over the counter, and price information is available by calling the company's recorded message at (214) 828-7587:

5% First Priority Senior Subordinated Debentures
Trustee: Chase Manhattan Trust, N.A.
Chase Financial Tower
250 W. Huron Road, Suite 220
Cleveland, Ohio 44113

4½% Second Priority Senior Subordinated Debentures (Series A)
4% Second Priority Senior Subordinated Debentures (Series B)
Trustee: The Bank of New York
101 Barclay Street, Floor 21 West
New York, NY 10286

United States:	
Franchised	2,960
Company-operated	2,191
Canada:	
Company-operated	475
	5,626

Licensed or Operated by Affiliates	
Japan	7,605
Taiwan	1,908
Thailand	1,105
United States	440
China	398
Mexico	241
Australia	177
South Korea	171
Malaysia	151
Philippines	149
Singapore	89
Sweden	47
Norway	45
Denmark	30
Spain	20
Puerto Rico	12
Brazil	9
Guam	8
Turkey	7
	12,612
7-Eleven Worldwide	18,238

State/Province	Total Stores
United States:	
Arizona	100
California	1,172
Colorado	230
Connecticut	53
Delaware	27
District of Columbia	18
Florida	452
Idaho	14
Illinois	149
Indiana	39
Kansas	16
Maine	25
Maryland	311
Massachusetts	109
Michigan	112
Missouri	81
Nevada	195
New Hampshire	20
New Jersey	206
New York	237
North Carolina	7
Ohio	15
Oregon	132
Pennsylvania	165
Rhode Island	11
Texas	286
Utah	111
Vermont	4
Virginia	604
Washington	212
West Virginia	23
Wisconsin	15
Canada:	
Alberta	129
British Columbia	147
Manitoba	49
Ontario	107
Saskatchewan	43
Total	5,626

All numbers as of December 31, 1998

Oh Thank Heaven.™

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